FINANCING ECONOMIC GROWTH OF SOME UNDERDEVELOPED COUNTRIES OF ASIA WITH PARTICULAR REFERENCE TO INDIA

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PREFACE

In recent years, underdeveloped countries of Asia have launched economic plans to utilise their human and material resources to improve the living standards of their masses. In many of them agriculture has for long been the mainstay of the people. They have accordingly embarked upon land reforms to improve their agriculture. Scarcity of domestic savings and lack of availability of capital equipment and technical know-how coupled with inadequate facilities for mobilising capital and credit are the main features of the economic and commercial organisation of these countries. A very small proportion of low national income is devoted to capital formation, while they depend for the sale of a few primary products for earning foreign exchange.

To take their economies to a 'self-generating' or 'take-off' stage, it is necessary to augment savings and investment through planned efforts and to supplement them through import of foreign capital, credits and even grants on Government level and through international agencies. For this purpose, investment is to be raised from about 5 per cent of national income to about 15 per cent of the national income. This is the main problem of financing economic growth in them. Population is their main asset and that too is ignorant, illiterate, and untrained. Means of communication and transport are in a backward condition.

In such conditions the State has to play a leading part in creating social and economic overheads and in reorganising the capital and the money markets through appropriate monetary, credit and fiscal policies. Hence in underdeveloped countries a great emphasis is laid on the growth of the public sector.

In Planned economies in these countries the Government or the planning authority has been called upon to fix priorities to utilise the limited resources to bring about rapid economic development and to lay down targets, physical and financial, to be achieved within a given period of time. The public sector has also been motivated by a desire to correct the disequilibrium in the balance of payments, to bring about price stabilisation, to counteract cyclical fluctuations in economic activities and to promote social objectives like reducing the inequalities in income and wealth distribution. The State has also to intervene to provide educational and training facilities of a technical nature for which financial resources are required which are beyond the capacity of the private sector.

Objectives of economic planning attract varying emphasis in different countries. In Laos, Taiwan, and Southern Viet-Nam considerations of national defence have been the primary determinants of Government expenditures. In Mainland China, the emphasis has been on the socialist transformation of the economy. In the Federation of Malaya, Hong-Kong, and the Philippines, fiscal policy has been designed to encourage private enterprise. In India and more recently in Ceylon, development programmes assume an increasing role for the public sector. Throughout the region, the pattern of fiscal policy has, in a greater or lesser degree, been affected by the desire to promote economic equality.

The shortfalls in Government revenue at a time of increasing expenditure have given rise to budget deficits in almost all countries except China Mainland. In the absence of other sources of finance, these deficits have to be financed through credits from the central bank or from commercial banks, thus resulting in

an increase in the money supply with the result that the price level has risen and efforts have to be made to keep it under check. In India, for instance, holding the price line is indispensable at present. Since 1961 the currency in circulation has increased by 30 per cent, while food production is almost stationary. The wholesale price index (1952-53 = 100) touched 143.5 in May 1964. Hence the price line must be held in check.

In almost all of them domestic savings are inadequate, China Mainland being the only exception. Foreign assistance in China Mainland has been on a small scale mainly from the U.S.S.R. In other underdeveloped countries, foreign assistance both on private and state level has been necessary to varying extent. They have had to reorientate their fiscal, monetary and taxation policies to attract foreign savings and assistance. Some of the international institutions which have recently been set up have been of invaluable assistance in providing foreign capital which has come both in the form of loans and equities.

I have ventured to make an objective study of the main features of the financing of economic growth in some underdeveloped countries of Asia with particular reference to India. The varying importance of different sources of raising finance, their effects are economy etc., have been sought to be analysed with particular reference to India. The period selected for study is coextensive with the period of economic planning. While analysing the trends of economic growth, I have drawn upon sources pertaining to the various countries and I have tried to draw my illustrations from as many countries under study possible.

I availed of literature bearing on the subject in the library of the Allahabad University and in the statistical laboratory of the Department of Commerce and Business Administration of the University. I also consulted literature in the library of the Delhi School of Economics, of the Institute of Economic Growth and of the Federation of Indian Chambers of Commerce and Industry . Delhi and I am grateful to the authorities of these institutions for providing me all legitimate facilities for study.

Dr. A.N.Agarwal, Head of the Department of Commerce and Business Administration, Allahabad University has been a source of constant inspiration to me and through his inspiring guidance and scholarly advice I have been able to complete this study. Even though extremely busy, he has nevertheless always been willing to spare a portion of his valuable time to look into my work, which I dare say in parts at least, bears the indelible mark of his guidance. I may, however, hasten to add that the responsibility for any shortcomings is entirely mine. I cannot express my feelings of gratitude to him for the interest taken by him.

Professor K.L.Govil, M.A., formerly Reader in Commerce and Registrar of the Allahabad University was also good and gracious enough to go through some chapters. His valuable advice stood me in good stead and he suggested source material which proved very helpful in completing the work. No words can express my feelings of gratitude for his affection and help.

My guide and supervisor, Professor D.N.Elhance, Professor of Commerce of Jodhpur University devoted time and attention in going through the manuscript and gave valuable suggestions. I am deeply grateful to him for his scholarly and helpful guidance.

The examiners of my thesis gave helpful suggestions. Accordingly, the bulk has been considerably reduced and greater attention has been paid to the promotional aspects of central banking.

If this work of mine were to see the light of day and induce interest in the reader in this fascinating subject, I should consider my labour amply rewarded.

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C O N T E N T S

TABLES

APPENDIX 'A'

CHAPTER I

INTRODUCTORY

During the last 15 years or so, there has been a great awakening in underdeveloped countries to the need of improving the living standards of their masses by increasing production and by improving the system of distributing income and wealth. For this purpose, economic planning is being adopted. A study of the methods adopted and of the results achieved would be interesting.

Underdevelopment is a relative term. It usually refers to the state of economic development of countries, which have low levels of real income and capital per head of population in comparison to the advanced Western countries. Low *per capita* income is responsible for poor savings, low investment, high propensity to consume, low productivity, low standard of living and poverty. Underdeveloped countries lack large-scale application of technology to agriculture and industry, subsistence production is generally prevalent, markets are comparatively narrow and manufacturing industry is usually unimportant.

According to a U.N.Report [1/], the term 'underdeveloped area' is applied to countries where '*per capita*' real income is low when compared with the *per capita* real incomes of the U.S.A., Canada, Australia and Western Europe. Alfred Bonne defines an underdeveloped country as one where income and consumption levels are conspicuously below the standard level, which exists in Western countries. To him, the concept of underdeveloped countries as given in the U.N.Report does not convey the dynamic element implied in the term 'underdeveloped', nor does it indicate the factors responsible for under-consumption. Another author [2/] has

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1/ Measures for the Economic Development of Underdeveloped Countries, 1949.
2/ 'The Economics of Development' : Jacob Viner, quoted from Economics of Underdevelopment, Dr. A.N.Agarwal and S.P.Singh, 1958.

written that an underdeveloped country is one which has good potential prospects for using more capital or more labour, or available material resources, or all of these to support its population on a higher level of living. He lays more emphasis on the prospects of raising the per capita income for an increasing population.

Capital is an important factor which should be considered while defining underdeveloped areas, because a high average level of income and economic performance in general is largely due to the high per capita rate of available capital resources. Bonne includes the 'Psychological Factor' - the measure of interest of the population in economic growth in the definition of underdeveloped area. The four criteria for the state of underdevelopment given by him are :-

(a) Low real per capita income

(b) Low rate of reproducible capital per capita and per unit of area.

(c) A favourable ratio of unused resources to population.

(d) A scarcity of entrepreneurial qualities in the population.

According to the point Four Programme proclaimed by President Truman 'Underdeveloped areas are those where more than half the people of the world are living in conditions approaching misery, where food is inadequate, disease rampant, where economic life is primitive and stagnant, and where poverty is a lasting and dangerous handicap.'[3] This is a more comprehensive definition of underdeveloped regions as it includes both sparsely populated and densely populated areas and not merely those where natural resources remain unused.

In the words of L.D.Stamp " a country may be underdeveloped because it has land which could be, but is not, actually productive or because existing production from its lands is below standard as evidenced by the yield of crop per unit area."[4]

3/ Quoted from 'Our Underdeveloped World', L.D.Stamp, P.19
4/ Ibid; P.79

Thus the underdeveloped world comprises a very diverse collection of countries and the heterogenity of the underdeveloped world should be borne in mind. There are great differences, as we shall see hereunder, in the economic level in underdeveloped countries themselves.

Features of Underdevelopment :

(a) The size of per capita income in underdeveloped countries is a fraction of per capita income in advanced countries. The per capita income of India in 1948-49 was about 57 U.S. dollars, while in 1958-59 it was about 61 U.S. dollars . In 1957, the Per capita income of Burma was $ 47; of Ceylon $ 118; of China Taiwan $ 88; and of Philippines $ 193. China-Mainland had a per capita income of $ 61 in 1956. In 1954, the per capita income of Malaya and Indonesia was U.S.$ 303 and $ 304 respectively. Pakistan and Thailand were having the per capita income equal to $ 49 and $ 85 respectively in 1956.[5/]

(b) Agriculture accounts for a large proportion of the total national income.[6/] As is evident from Table No. 1 the percentage of employed population engaged in agriculture, forestry, and fishing in Japan, U.S.A., and U.K. is much less than what it is in South East Asian countries.

Table No. 1

EMPLOYMENT STRUCTURE[7/]

Percentage Distribution of Economically active population

Country and year	Mining, Manufacturing and Construction	Agriculture Forestry and Fishing	Others (a)
1	2	3	4
China Taiwan			
1954	10.2	59.8	30.0
1957	10.7	57.7	31.6

5/ Percentages have been calculated from Economic Survey for Asia and Far East, Annual Report, U.N. (1958)
6/ See Appendix I
7/ ECAFE Bulletin, Vol. IX, No.3, December 1958, P.9, Table No.2
(a) Comprising Electricity, Commerce and Transport etc.

1	2	3	4
Ceylon			
1946	11.6	59.2	29.2
India			
1951	10.6	70.6	18.8
Singapore Federation			
1947	19.8	8.4	71.8
Malaya			
1947	10.3	65.1	24.6
Thaland			
1947	2.4	85.8	11.8
Pakistan			
1951	7.6	79.4	13.0
Philippines			
1948	8.9	71.8	19.3

The national income of India in real terms recorded a rise of 6.8 per cent in 1958-59 over 1957-58 according to the latest estimates prepared by the central statistical organisation. Of this rise as much as 5 per cent was contributed by agriculture alone and 1.8 per cent by other sectors together. At 1948-49 prices, national income for 1961-62 shows a modest rise of only 2.1 per cent over that of 1960-61. This order of increase was smaller than the annual average rate of growth of 3.4 per cent and 4.1 per cent in the First and Second Plan period. respectively. This rise in 1961-62 came mainly from sectors other than agriculture.[8/]

(c) The chronic underemployment is a characteristic of agricultural economy. This is because of the fact that non-agricultural occupations have not been growing at a rate commensurate with the

8/ Report on currency and finance for the year 1962-63, Reserve Bank of India : pp. 21-22

increases in population for lack of sufficient investment outside agriculture. Hence a growing labour force has had to be absorbed in agriculture. During the last few decades the increasing pressure of population on ~~the~~ land has resulted in chronic unemployment and underemployment in these countries. In India the population is now growing at 1.8 per cent per annum, while the planning commission estimated this rise at 1.25 per cent in 1956.

A major factor limiting the rate of economic growth and progress in many South East Asian countries is the pressure of population[9/], which keeps per capita income low, combined with a fairly high rate of population increase, which adds to the capital required to register any advance. When population is growing at an annual rate of some 1.6 per cent and the capital output ratio is about 2.5 : 1, a rate of four per cent net savings is required merely to maintain the existing amount of capital per person. Moreover, by the prevailing combination of high birth rates and high death rates, the proportion of children is high, the age distribution is unfavourable to production, and much of the investment in children is wasted from the economic point of view because of high rates of mortality at younger age.[10/]

(d) Agriculture in these countries is characterised by small holdings, poor credit, underdeveloped marketing facilities and primitive methods of production. Besides, these countries have a large indebtedness.

(e) Large-scale production in underdeveloped countries faces the obstacle of inadequate means for the acquisition and operation of the expensive capital equipment necessary for mass production. An increase in the rate of capital formation is a necessity for substantial progress in

9/ The population is growing at a rate of 2 per cent per annum in Indonesia; 1.75 per cent in Philippines, and between 1.8 per cent and 2.5 per cent in South Viet Nam. U.N.ECAFE Annual Report 1958 : P.68; The rate of increase in population in China (Taiwan) is 3 percent. See Population and Progress in the Far East; W.S.Thomson; p.367. The rate of increase in Pakistan is expected to be 1.5 per cent. See First Five Year Plan of Pakistan.

10/ U.N.,ECAFE Bulletin, Vol.VI, No.3, November 1955; P.32

industrialisation in the majority of the countries of the region. Due to low level of national income the margin for new capital formation out of savings is very small. The net rate of capital formation (inclusive of a small surplus for foreign investment) in the " Japanese final year of the plan appears to be close to 25 per cent, the rate of capital formation appears to be very small in other South East Asian countries. In China; Taiwan, the net total investment is expected to be 15.4 per cent of the net national income during the plan period. In Mainland China, the proportion of national income going to accumulation was placed at 20 per cent. The ratio of the net domestic investment to the national income in the Philippines is about 10 per cent. In the last year of the Indonesian plan period, the net rate of capital formation is expected to be 7.3 per cent as compared with an estimated 5 per cent rate before the Plan."[11/] The investment in India as percentage of national income has risen from about 7 per cent in 1951 to 11 per cent in 1961, and by the end of the Third Plan, it is expected to rise to 14 per cent.

(f) The transport system in these countries is poorly developed. These countries also lack in a steady supply of able organisers and various classes of technical personnel.[12/]

(g) The exports of underdeveloped countries are mainly composed of primary commodities and a little of processing food grains and manufactured goods mostly from industrially advanced countries. Their terms of trade are largely determined by the general trend of prices in the international trade of the primary products exported relatively to the prices of the imported manufactured goods. The purchasing power of the primary goods in the international markets declined very much from the latter part of the nineteenth century to the

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11/ Ibid : Vol. IX, No.3, December 1958 : P.19
12/ See Economic Bulletin for Asia and The Far East; Vol. XI,No.3, December 1960.

eve of the Second World War. 'The quantity of primary exports would pay, at the end of the period for only 60 per cent of the quantity of manufactured goods, which it could buy at the beginning of the period.' 13/ The prices of the primary goods, however, in the post war period as compared to the pre-war period have increased much.

(h) Reliance on imports for food supply is a special feature of Burma, Ceylon, China (Taiwan), Federation of Malaya, and Singapore, India, Indonesia, Philippines, and South Viet-Nam. India is relatively independent of external sources. In other South East Asia countries, the food imports are of critical significance in degrees varying with the size of the annual domestic crop. The larger import dependence of Ceylon, the Federation of Malaya and the entrepot economies is aggravated by the necessity of importing food. Among the countries more moderately dependent on imports, Indonesia, Pakistan, and the Philippines also have been food importers.

(i) A large part of national investment for economic development consists of expenditure on imports of capital goods, and this involves the utilisation of export proceeds, foreign aid, or the incurring of external indebtedness. This close direct relationship between development and external balance has caused serious anxiety to the countries of the region in their efforts to accelerate economic growth.

(j) In the post-war period, the economic growth of most of the South East Asian countries has been retarded by internal political disturbances, and to some extent, by the small intrusions in one country by the neighbouring nations. Upto 1957, the most serious problem before Burma, Cambodia, Ceylon, Federation of Malaya, Nepal, Indonesia, Pakistan and Thailand was to maintain internal security, law and order. The political division of Indonesia into Cambodia, Laos, North Viet-Nam, 14/

13/ U.N.Report on Relative Prices of Exports and Imports of underdeveloped countries : 1950 : p.7

14/ Democratic Republic of North Viet-Nam is a full fledged member of the communist block of nations.

and South Viet-Nam in 1954, the division of India and Pakistan in 1947 and the separation of Singapore from Malaya in 1946 were followed by internal political disturbances, the mass migration of population from one country to another and the division of economic resources both physical and natural. " In early 1956, ~~gh~~ the relations between South Viet-Nam and Cambodia reached a serious stage." 15/ The immediate effect of the Second World War on China was the downfall of the Nationalist regim. It was followed by "rapid fall in production and doubling the total Manchurian note issue. It resulted in severe inflation. The other cause of galloping inflation was the failure of the Nationalist Government's financial and fiscal policy and the widespread nepotism, inefficiency and corruption." 16/ In January 1948, Chinese communists tried to overthrow the Malayan Government and again in January 1957 some disturbance broke out between the Chinese and the Malayans 17/ Political instability continued in Nepal till 1956, and the same year in January, the direct rule of the king came to an end and the power went into the hands of the cabinet. Between 1956-57, the cabinet was dismissed twice and again recently in the beginning of 1961, the king dismissed the Government and took over charge himself.

In Indonesia, since August 1950, no less than seven cabinets have held office, and in February 1957, President Sukarno established the guided democracy creating the national council representative of all important forces including communists. The causes of political instability were : First, the political parties at the time of independence were splintered and fractionalised; Second, agricultural capacity of the country was incapable of keeping pace with the rise in population, and the Government machinery was mainly dependent on raw

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15/ A short History of Cambodia; Mortin F.Herz.
16/ An Economic Survey of Communist China; Yuan-Li-Wu : P.44
17/ The Diplomacy of the Far East Asia; 1945-58 : R.H.Fifield.

materials.[18] Throughout the past seventeen years of its existence, a number of Governments have changed in Pakistan and in 1958, General Ayub brought military rule by imposing martial Law. In Thailand, the combination of strong and effective bureaucratic Government and weak and disorganised extra Government organisations have made public control of the Government ineffective. In 1957, the unrest and dissatisfaction led to the suspension of the constitution and the parliament was dissolved. In October 1958, Field Marshal Sarit in a bloodless coup overthrew the entire system and established himself as a military dictator.[19]

(k) Almost all the countries in the region have a tropical climate. In Burma three physical factors are of particular importance. First, it has the predominance of North South valleys; Second, the country is divided into two distinct areas - the plains, delta and mountains. South of this area - the delta plain, which is interlaced with rivers and streams is the political and economic centre of modern Burma. The two regions join to form Burma proper. It has a very fertile land and plentiful rainfall. Burma has deep teak forests. British Borneo is largely covered with tropical rain forests merging at altitudes to great stretches of mountain moss forests and in the coastal low lands to fresh water swamp forests. It is flanked on the west and the south by shallow seas and on the north and east, the sea slopes steeply to the great depths. On the west coast, rice, rubber, and coconut are grown in abundance, while the north and the east coast are suitable for tobacco. In Cambodia, most of the people live along the Mekong river and utilise its fish and irrigation water. 'Cattle and pigs are raised in large numbers - the former for export and the latter for home consumption. Most of the population is found on the alluvial soils.[20] These are almost completely occupied by rice fields and

18/ Ibid
19/ Government and Politics of South East Asian Countries : G.M.Kahin.
20/ Introduction to Economic Geography;Klimn,Starkey,Hall & Piercy,P.453

intersected by a network of irrigation canals. The coasts are often subject to occasional typhoons.[21] Plantation agriculture is represented mainly by rubber, Rice, pepper, rubber and maize are important products and rice itself occupies 85 per cent of the tilled land.[22] Ceylon's economy to a large extent is centred on the cultivation of rice on irrigated land. " In 1953, about 9.7 lakh acres of land in Ceylon was under paddy cultivation."[23]

In Malaya, the western range is fertile and extensively developed, while the eastern range is covered by extensive forested mountains. This is the less developed area. The hot and humid climate is suitable for the production of rubber, coconut and paddy. Most of the plantations are near the sea, because they are convenient to coastwise shipping and rail connections with Singapore. " In 1952, Singapore handled 74 per cent of the imports and 67 per cent of exports of Malaya."[24] Hong-Kong's primary product is fish. Half of Nepal is under forests, one-fourth cultivable and the rest either alpine meadows or under perpetual snow.

Indonesia is characterised by the volcanic fertility of the soils and heavy rainfall throughout the year. Java is a narrow island with a series of volcanic mountains on its southern border. ' Rice the chief cash crop occupies about 40 per cent of the cultivated land.'[25] Sumatra has also a mountain fringe along the south western margin and a low land on the north coast. Only a small percentage of the land is under cultivation. Philippines is divided among more than 7,000 islands. Of them 6,620 islands have an area of less than one square mile each,

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21/ The Far East; A.D.C. Peterson : P.172
22/ Diplomacy of the South East Asia; R.H.Fifield : 1945-58, P.367
23/ India and Pakistan; O.H.K. Spate and B.H.Farmer : P.762.
24/ Diplomacy of the South East Asia,(1945-58), R.H.Fifield : P.399
25/ Economic Geography; S.N.Dicken : P.337

whereas eleven islands are of more than 1,000 square miles each. They comprise 95 per cent of the land area and have ninety per cent of the total population.[26/]

Thus it is evident from the above features that some of the underdeveloped countries are richly endowed with natural resources, others are deficient in many respects; some are almost wholly agricultural, others have an industrial structure of some sort; some possess very advanced civilization, while others are still in the tribal stage. A gradient and not a cliff separates the underdeveloped areas of the world from the developed areas when countries and regions are placed in an array. At the extremes the contrasts are dramatically sharp, but in the middle ranges blurring is unavoidable.

The problem of economic development is launching a take-off into sustained growth in poor and stagnant countries. Sustained growth implies or means a discernible rise in national and per-capita real income, widely diffused throughout the population, that continues for two or more generations. Barbara Ward[27/] calls it as 'the breakthrough into future growth'. This implies mobilisation of resources so that they may be devoted to instruments, procedures and work which increase the flow of goods later.

Categories of Underdeveloped Countries

There are four categories of underdeveloped countries :

First, there are countries with low enough per capita incomes to put them into this category, but they have unutilized known resources. They are currently undertaking enough industrialization and agricultural improvement to bring substantial increases in per capita income. Italy, Urgentina, Turkey, Ceylon and India, etc., can be put in this category. They have sufficient domestic savings and

26/ Governments and Politics of South East Asian Countries; G.M.Kahin, P.450.
27/ India and the West; Barbara Ward, See Chapter II, August 1961

foreign assistance to finance the capital formation needed to raise incomes. They are, however, confronted with bottlenecks, viz., capital supply, skilled labour, managerial and technical skills. They have backward sectors of the economy, limiting the rate of growth and making planning necessary. Further, growth is unevenly distributed among social groups and regions. Here the problem is that of sustaining growth, spreading its benefits more widely and reducing unemployment.

Second, there are countries like Burma, China, Thailand and Pakistan with very low *per capita* incomes, below $ 100 per year. They do not appear to have abundant resources in relation to the size of their populations. Here *per capita* income is currently rising and the rise in income has to be accelerated, not just sustained.

Third, there are countries which are poor and stagnant. They are relatively rich in resources, but *per capita* incomes do not show a rising trend. Indonesia falls in this category. *Per capita* income is higher than in India, Pakistan or China. It is not obviously rising and may even be falling as compared to 1939 or earlier. Here if the rate of population growth can be held within bounds, the hope for raising the *per capita* income significantly would be much better than in resource poor countries. Here the task is not merely to sustain or direct growth but to launch a process of growth that can become cumulative at some level of *per capita* income.

Finally, there are countries which are very poor with *per capita* income below $ 100 per year, which are stagnant and also poor in resources, viz., Libya, Cambodia, Viet-Nam etc. In Libya the *per capita* income is about 30 dollars per year.

Essentials of Balanced Growth

Chester Bowles[28/] mentions five requisites for rapid and

28/ Making of a Just Society : P.16, The University of Delhi 1963.

balanced growth in a developing country. These five essentials are :

1. Adequate capital - both domestic and foreign.
2. Enough goods and services to persuade people to contribute the personal effort that development requires.
3. Adequate skills for management, administration, etc.
4. A willingness and ability in over-crowded nations like India and Pakistan to curb a rapid population increase.
5. A unifying sense of national purpose with effective communication between the people and their leaders.

A list of common characteristics of underdeveloped countries is instructive. It helps us to understand the nature and the magnitude of the problem. At the same time, it requires a careful analysis of the causes of underdevelopment. 'The road to development is paved with vicious circles.' 29/ 'Yes, but some circles are more vicious than others.' 30/ The task of economic analysis of the development problem is to discover, which of these vicious circles are the basic causes of the others so that they may be broken ~~into~~ up to bring about sustained growth.

At this stage we may review the evolution of the idea of economic growth beginning with the views of the Classical economists.

The view of the Classical economists was that the development of capitalist economies was a race between technological progress and population growth, a race in which technological progress would be in the lead for some time, but which ultimately would lead to stagnation. Technological progress depended on capital accumulation, which would permit increasing mechanization and greater division of labour. The rate of capital accumulation depended on the level and trend of profits.

Marx's theory of development was the core of his system. With him development was not what it was with all the other economists of

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29/ 'Financing Economic Development' Benjamin Higgins; International Conciliation 1955.

30/ The Strategy of Economic Development; Albert C. Hirschman, (New York) 1958.

that period, an appendix to economic statics, but the central theme. He tried to show how the economic progress, changing by itself, by virtue of its own inherent logic, incessantly changes the social framework - the whole society in fact. He never underestimated the capacity of the capitalist system for economic expansion. In this respect, perhaps he was more optimistic than even Malthus or Mill. True, he expected capitalism to break down, but for sociological reasons, . not because of stagnation and only after a very high degree of development had been attained. According to Marx, ' it is the historical task or privilege of capitalist society to create a productive apparatus that will be adequate for the requirements of a higher form of human civilization.[31/] Marx laid a good deal more stress on technological progress as the motor of capitalist growth and he assigned a more important role to the entrepreneur. He saw more clearly than his predecessors and even his contemporaries the two-way relationship between investment and technological progress. Investment is necessary for technological progress, but technological progress also provides the opportunity for profitable investment. Marx regarded technical progress as labour saving and capital absorbing. According to him there was a tendency for the ratio of constant capital to variable capital to rise. In other words, there was a tendency for capital costs to rise relatively to labour costs or for capital per worker to rise. He seemed to regard that the capital output ratio as also the capital labour ratio would rise. The advantage in new techniques came from saving labour. According to him, unless the spread between the national income and the wage bill increases, the increase in capital per worker must result in a fall in the rate of profit. He considered technological change as the prime mover of the whole system. Capitalism brings a high stage of technological advance,

31/ History of Economic Analysis : Joseph Schumpeter; P.573

but eventually it leads to a bitter class struggle between workers and capitalists from which the workers will emerge victorious.

Schumpeter was not one of those who believed that the capitalist machine produces high rates of economic growth which offset the attendant social evils. He heartily enjoyed and endorsed the society and civilization produced by pure capitalism as well. He prefered the relatively uninhabited and undemocratic capitalism, accompanied by a high level of cultural attainment, which prevailed in World War I, to the modified capitalism that has developed since. Even the semi-feudal capitalism of prewar Japan struck a responsive chord in Schumpeter. Schumpeter considered the existence of a sharply defined class structure a small price to pay for the continued economic and social progress which he believed unbridled capitalism brings.

Much as he admired the capitalist system, however, Schumpeter also shared the gloomy prognosis of the Classical School and of Marx. He believed that capitalism will eventually stagnate and break down. This prospect was for him sadening indeed, especially, since in his view, the breakdown would come only from the lack of appreciation of what capitalism can do and the conditions which it needs in order to prosper. According to Schumpeter, not the failures of capitalism, but its very success, would lead eventually to the slaughter of the goose that lays the golden egg.

In his insistence that the most important part of private investment is determined by long-run factors, not directly related to recent changes in income, output, sales, and profits, Schumpeter made his major contribution to the theory of investment. He laid particular stress on what he called 'innovation' as the mainspring of autonomous investment. He thought of innovation in general as any change in the production function which would bring an increase in output and listed

five major forms of innovation.[32] (1) The introduction of a new good. (2) The introduction of a new method of production. (3) The opening of a new market. (4) The conquest of a new source of supply of raw materials. (5) And the carrying out of the new organisation of any industry.

However, the main feature of Schumpeter's system is his stress on the role of entrepreneur in economic development under capitalism. According to him the supply of entrepreneurship is the ultimate determining factor of the rate of economic growth.

Harrod's theory is directed towards an explanation of the secular causes of unemployment and inflation, and of the factors determining the optimum and the actual rate of capital formation. Although clearly distinct from theories of equilibrium or of comparative statics, Harrod's theory is nevertheless related to them, and it uses those concepts and tools of equilibrium theory and comparative statics that are serviceable in analysing trends.

The Classical School believed that capitalist development would end in stagnation. Marx and Schumpeter thought that it would end in complete breakdown. The import of Harrod's theory is that maintaining full employment without inflation is extremely difficult in a capitalist society, and the cumulative movements away from equilibrium are always around the corner. Hensen, in contrast, presented the bright vision of a stable yet growing capitalist economy and argued only that the achievement of such an economy required appropriate monetary and fiscal policies.

Thus economic growth leading to development of economy requires investment of a certain order to stimulate it. The Classists, Marx, Schumpeter, Harrod, Hensen, and other writers, differing in detail, laid emphasis on the conditions leading to the accumulation of capital, which is necessary to bring about economic growth.

32/ The theory of Economic Development : Joseph A.Schumpeter; P.66, (1955)

Economic development is fast becoming a well-developed branch of economics. It is defined 'as a many sided affair.'[33] Economic development is not an end in itself. It provides more hope and more opportunity for an ever increasing number of persons. The really meaningful results of economic development are increases in the well-being, political and spiritual as well as economic, of individual citizens. Its ultimate objective is the fullest possible use of the economic resources available to the country, that is, its man power, its natural resources and the skill in organisation of its people applied to increase the supply of goods available for consumption, for the real income of its citizens in order that every one may have a better living than he has today in underdeveloped conditions. Economic development is an extremely complex process. It is more than an economic phenomenon. It depends largely on social, cultural and political factors. A country can hardly flourish, if social attitudes are hostile to saving, adoption of new techniques or occupational mobility or if there is political disorder in the country. Even geographical factors seem to play a part in it, 'for it is perhaps more than an accident that the temperate countries of the world are more developed than the tropical countries.'[34] The rate of these extra economic factors in development is, however, difficult to assess and more difficult to control.

Economic development implies change both of economic and non-economic factors. Change involves disturbance of settled ways. How much disturbance people would stand in order to secure a modest improvement in their standard of living in future, is rather problematical. But, 'only more economic development offers any hope of escape from the problems which economic development itself has already brought forth- escape from the problems of population pressure on the land and in the

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33/ 'Budgeting for Development', U.K.Hicks, Central Bank of Ceylon Bulletin; P.8, June 1957.

34/ 'The Theory and Reality of Economic Development, B.B.Das Gupta : Central Bank of Ceylon Bulletin; P.10, November 1955.

cities; escape from the problems of lack of jobs and outlets for the ambitions of the educated.[35]

Growth and Development

There are certain preconditions or pre-requisites for development. The first of these is the recognition that social reform and economic strategy are two sides of the same coin - the single strategy of development. This ultimate identity can be best expressed by saying that the problem of the underdeveloped countries is not just growth but development. Development is growth plus change and change in turn, is social, cultural, political as well as economic and qualitative as well as quantitative. A direct corollary of this new approach to development is that the purely economic indicators of progress are seen to provide only limited insight and might conceal as much as they indicate.

In this connection, one important aspect concerns the relationship of income distribution to economic and social development. The economic objective of all increase in income will be most meaningful only if 'the rate of growth of incomes goes hand in hand with improvements in internal income distribution, and if the social benefits of the improvements are widespread.'[36] The desirable goal in this respect is an income distribution more equal, or at least not more unequal, than at presnet.

Secondly, there should be a growing realization of the importance of human factor in economic development. This is due to the recent discovery that economic growth in the advanced countries appears to be attributable in larger part than was previously recognised to human skills rather than to capital. In this respect, the development of human resources becomes important not only as one of the major objectives of and a necessary pre-requisite for, economic development but also as a factor

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35/ The Diplomacy of Economic Development; Eugene R. Black : P.2

36/ U.N.The National Development Decade, United proposals for Action, P.2.

which directly contributes to economic development.[37/]

Social development does not automatically result from economic growth. To assume that economic growth automatically leads to social development is to ignore the deeper insights, which could be gained concerning the inter-relationships of social and economic factors in development. Social development should not be made a dependent variable of economic development. Indeed, the two should be considered as interdependent variables. The general assumption appears to have been that social development and social change are synonymous. Of course, all economic growth will automatically result in some sort of social change, but there is no certainty that the change will, at the same time, guarantee social development. The social problems which resulted from the industrial revolution in England bear testimony to this.

'Economic Development is the continuing process of increasing the capacity of a nation to produce valued goods and services so as to achieve rising standards of living for the people.[38/] The goals of economic development regarding raising the current living levels, providing for faster growth to increase consumption later, increasing employment, improving the distribution of income, etc., are fixed by the people themselves. These objectives react favourably on each other. For example, a high level of production is facilitated by a high level of employment.

Economic Planning - A Technique of Economic Growth

Economic growth of a nation can be resorted to either through overall economic planning or through the operation of free private enterprise coupled with partial economic planning in which resources may be applied for developing individual sectors. Before the war and even

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37/ Economic Bulletin For Asia and The Far East, Vol. IX, No.2, September 63. Also see : The Relation between Political and Economic Development; W.W.Rostow - Paper No.C/56-32, M.I.T.

38/ U.N.Economic Bulletin for Asia and the Far East : P.2, Vol. VII, No.3, November, 1956.

for some time after the war economic growth of the countries continued without resorting to economic planning and in countries like Ceylon and Burma, where earlier long term economic plans were prepared planning had to be dropped in the middle due to lack of sufficient economic data. But, recently in almost all the underdeveloped countries of South East Asia, long term economic plans have been prepared for furthering economic growth.

Economic planning implies fixing of the priorities for economic development and channelling the available resources into them with a view to getting the maximum possible utility. It is a method of spraying of investment over a wide range of development targets, comprising every field of primary and secondary industries, communications and transport facilities and social services etc., with a view to making possible a process of balanced growth. Planning is " the means by which the lines of communication are kept open between those who make decisions, those who 'illuminate' (allocate resources) them and those who carry them out.[39/]

Unless planning involves first and foremost a bringing together of the existing claims on a country's resources - that is, unless it is based not on a single assumption, but on an appropriate range of assumptions some induced and some duduced - the tools of economics cannot be safely and efficiently employed as a means of illuminating choices. Neither economics nor any other academic discipline in and of itself will tell us just what the scope and the magnitude of investment ought to be in a given country. These disciplines can suggest orders of magnitude and help us to Judge whether plans, projects, and policies are well-related to one another. But they cannot make economic development any less of the three sided problem. Plans and projects must be checked and coordinated with the actual possibilities, with what really people want in the way of growth and change and with what they are prepared to

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39/ The Diplomacy of Economic Development : Eugene R. Black : P.32(1959-60).

sacrifice. Otherwise, planning can lead at best to waste and at worst to the encouragement of extravagent forms of coercion.

Conflicts in Growth

At any given time, in any country, rich or poor, there is a conflict between the demands of growth itself and the demands which growth is supposed to serve. At any given time there is a conflict between the demands of growth and the demands for social welfare, between the demands of growth and the demands for economic security and employment for all, between the demands of growth and the demands for cultural development. In poor countries today these conflicts are particularly acute. In the post war period, most of the developing countries are involved in bringing about rapid and self-sustained growth, so as to make their nations strong and powerful to remove poverty and unemployment, in providing modern social services and bringing about equitable distribution of wealth. But always at any given time there must be a choice between more of these ends and more of growth itself.

The use of planning largely to keep the lines of communication open among those who make decisions, those who 'illuminate' them, and those who carry them out, is the most effective way to achieve a rational and democratic resolution of the conflicts and contradictions which are inherent in the growth process... Planning cannot help, but promote better answers in terms of growth. Furthermore, it can encourage policy makers to focus upon the necessity for engineering an escape from poverty and to make this idea a catalyst for transforming into constructive patriotism the nationalism which is rampant in the underdeveloped world.[40/]

40/ Ibid : p.35

Infrastructure of Growth and Development

Development planning which has replaced the former ad-hoc activities of entrepreneurs and public authorities, includes not only the elaboration of new income-producing activities, but also planning techniques for the collection, allocation and spending of funds usually in a number of years in advance. Planning thus offers the public a clear notion of the connection between various branches of economic life and thus stimulates cooperation and support and faces those incharge of development activities to keep the line within the scope of available resources and the provisions laid out for their expenditure. In underdeveloped countries a well-conceived development plan linked to an investment plan offers better prospects for the attainment of developmental goals than uncoordinated development ventures.

In all the countries of the region where planned economic development has been resorted to, increasing attention has been given to the basic development in agriculture. Reconstruction and rehabilitation require a vast outlay of capital. Hence the state has been called upon to take initiative towards basic economic development. The increasing role of the state in the economic activities of countries of the region is indicated by the emergence of the governmental capital outlay as distinct from the private capital outlay in their economic development programmes. Public investment in the initial stages of economic development in most South East Asian countries is playing an increasing role. Public undertakings are necessary first, to provide facilities of power, rail roads and communications which are basic to further developmental investment; and second, to promote investment in vital areas where private initiative, capital and technical know-how are lacking. Further, the state has to play an active role in providing health, education, and

technical research services. The role of public investment should be determined from the viewpoint of economic effectiveness, which should be measured in terms of alternative uses of investible resources to meet the country's objectives as well as the relative efficiency of public vs private enterprise. To illustrate the point, allocation of finance to various items is given for plans in some underdeveloped countries.

The budget, which was adopted in September 1957 by the National Assembly of North Viet-Nam allocated 42.5 per cent of the total expenditure to economic development; 21 per cent to defence, 11.9 per cent to health, education and welfare, and 10.4 per cent to government administration.41/

In the six year development programme of Ceylon a total outlay of Rs.2,500 million has been envisaged. Its allocation over the various expenditure heads is as follows : -

Table No.2

Six-Year Programme - Distribution of estimated expenditure.42/

(Crores of Rupees)

Expenditure heads	Amount in thousands of rupees	Percentage of the total expenditure	Percentage of the economic project
1	2	3	4
Defence	94.623	3.74	
Administration	89.477	3.54	
Social services	402.738	15.93	
Economic Projects	1,941.948	76.79	
Public Utilities	837.621	33.12	43.13
Agriculture & Irrigation and Fishries	922.602	36.48	47.51
Industry	111.799	4.42	5.76
Rural development & Village Works	57.550	2.28	2.96
Tourism	12.376	0.49	0.64
TOTAL	2,528.786	100.00	100.00

41/ 'Economic Development in North Viet-Nam'; Theodore Shabad : Vol. XXXI,No.1, P.41, March 1958. Journal of Pacific Affairs.

42/ Central Bank of Ceylon Bulletin; P.32, August 1955

A ten year plan of development with a total x investment cost of Rs.13,601 million (U.S.$ 2,856 million) has been submitted by the National Planning Council of Ceylon to the Government. Of the total, the planned public investment is placed at Rs.8,337 million or 61 per cent, while private investment is expected to account for Rs.4,409 million or 32 per cent. The remaining Rs.255 million is to be contributed by the public under a 'self help' programme. About 22 per cent of the total investment expenditure is to go to agricultural sector for its development. Expanded production of rice and the virtual transformation of fishing industry are to account for a large part of this outlay. About 17 per cent of the total investment outlay is for the development of large and medium sized industries, and another 3 per cent is for the development of cottage industries. More than 9 per cent of the total investment outlay is allocated for the export sector with a view to replanting 12 per cent of the tea acreage by 1968; export earnings in 1968 are expected to rise by 35 per cent.[43/]

The Second Five Year Plan of Pakistan running from 1960 to 1965 is estimated to cost Rs.19,000 million : Rs.11,500 million in the public sector or about 60 per cent, and Rs.7,500 million in the private sector or about 40 per cent. Thus, the proposed development expenditure in the Second Five Year Plan of Pakistan is approximately 50 per cent larger than in the First Five Year Plan. The public sector programme is larger by 65 per cent and the private sector programme by 35 per cent. In early 1964, the National Economic Council approved the outline of the Third Five Year Plan (1965-70) of Pakistan which will have a total outlay of P.Rs.4,950 crores (two-thirds in the public sector) as compared to P.Rs.2,300 crores for the Second Plan; the proposed outlay will be equally divided between the Eastern and Western regions. The

43/ I.M.E. 'International Financial News Survey; Vol.XI,No.50 P.397, June 26,1959

foreign exchange component of the Third Plan will be reduced to 30 per cent as compared with 43 per cent during the current Plan.[44/]

China (Mainland) started its First Five Year Plan in 1953. During the plan period, a total sum of U.S.$ 32,572 million ~~were~~ was to be spent on the development of the economy, education and culture. The investment in capital construction in these five years was to be U.S.$ 18,165 million. Of this sum, 58.2 per cent was to be spent on industrial sector. Of the total investment in industrial capital construction 88.8 per cent was expected to go to heavy industry and 11.2 per cent to light industry.

Table No.3

Planned Percentage Investment in Capital Construction in[45/] China : Mainland

Industry	58.2
Agriculture, Forestry and water conservancy	7.6
Transport, Post & Tele-Communication	19.2
Trade, Banking, Reserves of Materials	3.0
Culture, Education and Public Utility	7.2
Development of Urban Public Utility	3.1
Other items	1.1
TOTAL	100.0

The Five Year Plan for the Federation of Malaya envisages an expenditure of U.S.$ 452.7 million. Of this expenditure, 25.4 per cent has been assigned to agriculture mining and industry; 25.2 per cent for the development of transport and communications, 7.9 per cent to power development, 9.5 per cent to education, 5.2 per cent for providing medical facilities and in financing rural health schemes and 7.4 per cent to municipal public works and low rental housing programme.[46/]

The Five Year Development Plan of Indonesia calls for a total investment of Rupiah 30 billion (U.S.$ 990), of which the investment

44/ Reserve Bank of India Bulletin, April 1964. P.413

45/ Percentages have been calculated from the First Five Year Plan of China.

46/ Governments and Politics of South East Asian Countries: G.M.Kahin; P.294

in the public sector is to account for Rupiah 12.5 bullion (U.S.$/412.5) and the rest in the private sector. For the development of mining and manufacturing, 25 per cent of the expenditure was allocated.

Table No.4

Indonesia's Investment Budget 1956 to 1961 47/

Sector	Percentage allocation
Agriculture	13.0
Power & Irrigation	25.0
Industry & Mining	25.0
Transport & Communication	25. 0
Education, Irrigation and Welfare	12. 0
TOTAL	100.00

The First Five Year Plan of Nepal 48/ envisaged an expenditure of rupees 33 crores. Of this Rs.10.4 crores were allocated for the development of agriculture and irrigation, Rs.11.2 crores for the development of transport and communication and Rs.2.4 crores were allocated for the development of manufacturing and mining. The Second Five Year Plan involves a total expenditure of about Rs.195.9 crores. Of this, agriculture is to account for Rs.44.9 crores and the non-agricultiral sector is to account for Rs.151 crores.

The total outlay of Rs.2,690 crores was originally estimated to be spent in the First Five Year Plan of India in the public sector, but the actual outlay at the end of the plan came to about Rs.1,960 crores. The total estimated cost in the public sector of the Second Five Year Plan of India was Rs.4,800 crores, of which Rs.3,800 crores was to be spent on development projects. The actual outlay is estimated to be of the order of Rs.4,600 crores. During the same period, the outlay in the private sector is expected to be about Rs.2,400 crores. The Third Five Year Plan proposed an outlay of Rs.7,250 crores for the public sector. Of

47/ Indonesia's Economic Stabilisation and Development; B.Higgins: P.178, 1957

48/ First Five Year Plan of Nepal. Also see ECAFE Bulletin,Vol.VII, No.3, P.32, November 1956.

this, about Rs.1,050 crores will represent current outlays by the central and the state governments. Investment by the private sector is estimated at Rs.4,000 crores.[49/]

Although Thailand does not have a formal comprehensive plan for economic development till now, there is a series of developmental programmes for individual sectors under the direction of various ministries. Among these plans, the most important are : a second highway built at an estimated cost of Baht 1,615 million; improvement of railways at a total cost of Baht 1,268 million; modernisation of air transport and improvement of livestock. A rice seed improvement project, will cost Baht 4,000,000 million. The x Chao Phya River Barrage Project costing about Baht 930 million, when completed will help to irrigate an additional area of 2.3 million acreas.[50/]

The plans of the countries differ widely as to their nature, magnitude and scope. First, most of the plans are confined to the activities proposed for the public sector, although some, for example those of China Taiwan, India, Pakistan, and Philippines attempt to give broad estimates of the expected developments in the private sector as well. Further, some are drawn up comprehensively like those of India, Pakistan and Mainland China with quantitative data on all major items such as national income, population, investment sector by sector, planned targets of production and trade, while others provide merely data on public expenditure or investment and give inadequate idea of the industrial and economic development expected as a result of the plan. The examples are : The Five Year Capital Expenditure Plan of the Federation of Malaya, and the Five Year Economic and Social Development programme of Philippines.

49/ For details see Five Year Plans of India

50/ ' Spotlight on Thailand' Eastern Economist; P.256, February 22,1957

The Plans also differ in their timing. While Burma and China Taiwan have drawn up four year plans, India, Indonesia, Malaya, China Mainland, Philippines, Nepal and Pakistan have drawn up their Five Year economic plans. The First Plan of Ceylon was for six years and the Second is a ten year plan. Thailand announced that the Government's six year development plan would be launched for the first time in October 1961.[51] There are wide divergencies between the countries regarding the relation of population to natural resources, degree of industrialisation, extent of capital accumulation and other basic economic and social characteristics. Therefore, the problem they face in regard to planning differs from country to country.

There are some important similarities also. In many, the potentiality of population growth is associated with high birth rates and decreasing death rates. Health, education and skills of the population still require substantial improvements if they are to be brought to levels commensurate with higher levels of economic productivity. In most countries, rates of net capital formation are low and the rates of utilisation of available resources are kept down by scarcity of complementary factors, particularly an inadequate amount of social and economic overhead capital and shortages of entrepreneurial talent. The backward state of economy of most countries is due to their being for a long period under subjugation, the political independence having been achieved only recently. In any case it would appear that a stage has now arrived when a more detailed consideration has to be given to the problem of economic development in the region, how the resources - domestic and foreign - could be augmented and the role, the public and the private enterprise should play in economic development.

The more important problems faced by the countries of the region in implementing their development plans are (a) inadequacy of

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51/ I.M.F., International Financial News Survey : Vol.XII, No.74, P.598, December 9, 1960

capital and foreign exchange; (B) shortage of trained manpower and technical know-how and (C) instability of primary commodity prices.

Objectives of Economic Development Plans

The general objective of economic policy shared by all countries of South East Asia is to bring about economic and social advancement and to achieve higher standards of living by increasing output sufficiently within a short time and simultaneously to lay the foundations for further expansion of ~~the~~ their economies in the more distant future. To this end, the objective is to raise the rate of investment and to develop other activities conducive to economic development.

The countries of the region have set up targets of production, savings and investments in their respective plans. The state in these countries will encourage, facilitate, assist or undertake measures to achieve these goals. To promote and initiate ventures in new fields hitherto unexplored by private enterprise, Government have often taken the initiative in installing a few units or participate with ~~pri~~ private enterprise in the establishment of such units. In India, this field is clearly defined under the Industrial Policy Resolution of 1956 of the Government of India.

In most of the newly independent underdeveloped countries, there has been an urge for economic independence so as to reduce dependence on imported manufactures. Besides, a majority of the countries of the region have been handicapped in planning and programming by the fluctuations in their foreign exchange earnings as they mainly depend on a few primary exports for the maintenance ~~of~~ of their prosperity.52/

In Burma, China, Cambodia, Nepal, Indonesia, Federation of Malaya and India the immediate objective was to make good the

52/ See table on page 113, Economic Survey of Asia and Far East 1957

devastation brought by war. Therefore, they have given prime importance to the restoration of agriculture, mining, industry and transport to pre-war levels.

In Indonesia, it is hoped that during the plan period 3 per cent annual increase in national income can be maintained and the *per capita* income is to rise by 1.3 per cent per annum; with a marginal savings (and investment ratio) of 40 per cent, 0.52 per cent of *per capita* national income can be set aside each year for new capital formation; with 40 per cent of the increase in national income allocated to capital formation each year, 60 per cent of increase will be made available for raising the standard of living. To achieve this level of savings and investment, the Government measures to stabilise the economy and to assure a healthy monetary system are the essential preconditions. By the end of the First Five Year Plan capital formation is expected to reach the level of about 8 per cent of national income. By the end of 1965, it is to reach a target of 12 per cent.[53/] The goals to be achieved in the First Five Year Plan of the Republic of China are : The laying of a preliminary foundation for socialist transformation of agriculture and handicrafts; and a foundation for the socialist transformation of capitalist industry and commerce.[54/] The Second Five Year Plan of Nepal aims at raising the national income by 30 per cent over the plan period and ~~thx~~ to create 500,000 new jobs. Emphasis will be on gradual industrialisation, intensification of agriculture and the provision of adequate social services, and also bringing about a gradual reduction in inequalities of incomes.

The objectives of the First Five Year Plan of Pakistan were : Raising of the national income by 15 per cent and the *per capita* income by 7 per cent; to improve the balance of payments position of the country

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53/ Indonesia's Economic Stabilisation, B.Higgins: P.49,1957

54/ First Five Year Plan of China : P.1

by increasing exports; to increase the employment opportunities sufficiently; and to make a steady progress in providing social services.55/ The Second Plan of Pakistan aims at promoting the welfare of the people and at raising the standard of living of the common man by developing the human and material resources of the country; by making provision for the basic necessities of life - food, clothing, and shelter - to meet at least the minimum requirements by providing increased educational and health facilities and opportunities for gainful employment, and by securing social justice.56/ The Third Plan, which is expected to create 5 million additional jobs, aims at a 30 per cent rise in national income and a 15 per cent rise in per capita income. Exports are expected to rise to an annual level of P.Rs. 400 crores by 1970, compared with the existing level of P.Rs.280 crores.57/ The Five Year Plan of Philippines (1950 to 54) laid emphasis on the development of basic industries, consumers goods industries and transportation.58/ Another plan formulated in 1954, aimed at increasing national production, providing more jobs and raising of the incomes of the rural masses. In the new five year plan (1957-61), emphasis has shifted to the industrialization of the country and providing employment to 15 lakhs of people.

The objectives of the Five Year Economic Development Plan of South Viet-Nam are to establish the basic elements for an independent national economy and to initiate projects directed towards the healthy development and growth of the economy. In the plan, priority is given to agricultural development with only 9.1 per cent of the total planned public expenditure going to the manufacturing and mining industries. The plan as outlined, will also be concerned with the public works and social welfare. The First Five Year Plan of North Viet-Nam emphasises the

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55/ First Five Year Plan of Pakistan.

56/ Outline of the Second Five Year Plan of Pakistan : 1960

57/ Reserve Bank of India Bulletin, April 1964, P. 413

58/ Colombo Plan, 1955, P.128. Also see The Five Year Economic And Social Development Program for 1957 - 1961, National Economic Council, Philippines, January 3, 1957

development of light industries to meet the shortage of consumer's goods, cover urban unemployment and train the skilled workers and to accumulate the capital necessary for the ultimate development of heavy industry.[59/]

The six year Programme of Ceylon aimed at increasing the productivity of the export sector, expanding the area of land under cultivation, raising the yield per acre of land and promoting the industrial sector. The Ten Year Developmental Plan of Ceylon aims at increasing the national income by 36 per cent and the <u>per capita</u> consumption by 19 per cent by the end of 1968.[60/] The six Year Development Plan initiated in October 1961 aims at an annual increase of 5 per cent in gross national product, compared with the present rate of 4 per cent; and of 3 per cent in <u>per capita</u> income compared with the present rate of 2 per cent. Agricultural production is to be expanded by an average of 3 per cent annually, and industrial income is to be raised from 10 per cent of gross national product as at present to 12 per cent. Other developmental goals include the expansion of highway and railway facilities and higher exports.[61/]

The following are the targets of employment of the plans of some underdeveloped countries :

Table No.5

The Expected Addition to the Labour Force During the Plan Period and the Employment Targets[62/]
(In Millions)

Country	Addition to labour force during the plan period	Existing unemployment	Employment targets
China (Taiwan)	0.4	0.297	0.2
India (Second Plan)	10.0	5.3	9.5
Pakistan	2.0	-	0.2
Philippines	* 1.4	1.2	1.5
Ceylon(Ten Year Development Plan)	-	-	1.4

59/ 'Economic Development in North Viet-Nam'; Theodore Shabad: Journal of Pecific Affairs, Vol.XXXI,No.1,March,1958.
60/ I.M.F.,International Financial News Survey, Vol.XI,No.50, P.397, June 26,1959.
61/ Ibid: Vol. XII, No.74, P.598, December 9,1960.
62/ ECAFE Bulletin,Vol.IX,No.3,P.18,Table No.11,December 1958.
* I.M.F.,News Survey,Vol.XI,No.50,P.397.June 26,1959

Conclusion :

Almost all countries of the region are now operating under the guidance of a plan of some sort to advance economic development, but the suitability of the plans and the extent of implementation differ widely among them. Some of them are still seeking political stability or fighting against inflation. In them the creation of favourable basic condition for economic development is perhaps more important than immediately embarking upon an ambitious development plan. Most countries of the region have planned an investment rate of about 15 per cent[63/] With this investment rate and adequate investment efficiency, they should be able to achieve a 5-6 per cent growth rate of national income and a 3 per cent growth rate of *per capita* income. This rate of income growth would also narrow the gap in living standards between developed and underdeveloped countries. Many countries have, however, not been able to achieve this rate due to bad weather and adverse terms of trade.[64/] The more fundamental problem has been to absorb effectively and efficiently this or a higher rate of investment into the economy to gather momentum for a take-off.

The ability to invest can be changed by development efforts. Hence importance is attached to the strategy of development. The provision of economic and social infra-structure has greatly widened the horizon of investment in directly productive activities in the last decade, though there have been instances of wastage of public spending in these fields. Development in education and health has increased the absorptive capacity in many ways, but not all social welfare expenditures have been conducive to increased capacity to create wealth. In low income countries non-productive social expenditures should indded be resisted by a Government which is committed to providing a more or less permanent basis for a steady improvement in the level of living. Inducements have also been offered to private investment.

63/ ECAFE Bulletin : Table no.2,P.5,Vol.XII, No.3,December,1961
64/ Ibid: See table I.

An increase in absorptive capacity does not necessarily mean that all investment gives a maximum output. Overinvestment in certain sectors may result in idle capacity and create strains in other sectors of the economy. A balanced development between infra-structure and directly productive activities and between agriculture and industry in the public investment programmes, taking into account the related economic activity in the private sector requires attention from the planning authorities.

A country may be able to achieve a take-off in economic growth by boosting the absorptive capacity to realise a 15 per cent or higher rate of investment and by maintaining an adequate investment efficiency for a number of years, but it does not mean that the take-off has to be entirely self-supported. In view of the low levels of saving, many underdeveloped countries of the region may not be able to attain the stage of a self-sustained growth within about 20 years. During this critical period, a foreign aid generated take-off, which is to lead to a self-sustained growth, becomes a vital necessity.

The attack on poverty in underdeveloped countries has become an international concern and the bulk of external resources provided to the underdeveloped countries of the region have been public funds. The tendency for such funds is to increase and to be extended over a longer period. This tendency is to be appreciated, but it is necessary to integrate external assistance closely with national development plans. Foreign assistance can be effectively used in countries, where the absorptive capacity is substantial and paid back where the capacity to repay is considerable. The extent of the capacity to repay depends on two factors : One, the development efforts of aid receiving countries and second, the trade policy of aid giving countries regarding the exports of aid receiving countries. This policy should be liberalized. The gap

between the absorptive capacity and the capacity to repay, as well as the need to improve the absorptive capacity have to be filled by grants. Domestic savings efforts must be vigorously pursued so that eventually self-sustained economic growth may be achieved. That will be the permanent basis for a proper solution for raising the national and _per capita_ income and for augmenting the living standards of the masses.

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CHAPTER II

DOMESTIC FINANCING AND ECONOMIC GROWTH

Economic growth centres, inter alia, largely on capital formation. The best known measurable indicator of economic growth in terms of productive assets is the rate of capital accumulation. It is contended that growth necessarily implies a proportionate shift of resources from consumption to capital accumulation. To make more goods and services available in future, the proportion devoted to consumption is to be lowered so that capital accumulation may be formed. This need not necessarily imply lowering the absolute level of current consumption; indeed, economic growth may permit some rise in it even in the short run. But it does mean that the ratio of capital to natural resources, and of capital to labour, must increase if _per capita_ production and, ultimately, _per capita_, consumption, is to rise. Only in this way, can a stationary or stagnant economy be transformed into a developing or dynamic economy.

In developed countries like the U.S.A. and Japan and in a few underdeveloped countries like Ceylon, capital formation ranges from 10 to 20 per cent of national income, while in most of the underdeveloped countries like Indonesia, India, and the Philippines the rate of capital formation ranges from 5 to less than 10 per cent.[1] Gross domestic savings in Pakistan in 1958-59 were roughly 7.5 per cent of the public and the private savings.[2] The following table gives the trends in capital formation in some underdeveloped countries .

1/ Three Year Programme of Economic and Social Development (1959-60 to 1961-62); P.25, January 2, 1959; Manila-Philippines.

2/ Government of Pakistan - outline of the Second Five Year Plan (1960-65) : P.12, January 1960.

Table No.6 3/

Rate of Savings and Capital Formation in a Few Selected Countries between 1948-1956

Year	1948	1949	1950	1951	1952	1953	1954	1955	1956
Country									
Burma :									
1.Savings	10.8	16.4	15.4	19.1	23.6	25.2	19.8	21.7	21.2
2.Capital formation	16.9	8.1	10.2	12.9	18.2	19.0	22.0	21.0	18.5
3.Savings over capital formation	- 6.1	8.3	5.2	6.2	5.4	6.2	- 2.2	0.7	2.7
Ceylon:									
1.Savings	6.8	7.3	14.4	15.0	6.3	7.6	16.4	16.8	13.5
2.Capital formation	6.2	9.0	10.6	11.7	13.4	12.0	10.0	11.3	12.3
3.Savings over capital formation	0.6	- 1.7	3.8	3.3	- 7.1	-4.4	6.4	5.5	1.2
China Taiwan :									
1.Savings	-	-	-	17.3	17.1	12.2	8.8	10.6	-
2.Capital formation	-	-	-	22.2	22.0	18.1	17.9	14.6	-
3.Savings over capital formation	-	-	-	-4.9	-4.9	-5.9	-9.1	-4.0	-
Indonesia :									
1.Savings	-	-	-	6.4	10.1	-	-	-	-
2.Capital formation	-	-	-	4.7	5.2	-	-	-	-
3.Savings over capital formation	-	-	-	1.3	4.9	-	-	-	-
Malaya :									
1.Savings	-	11.6	29.5	27.2	16.6	11.1	-	-	-
2.Capital formation	-	10.6	4.5	6.1	11.9	10.4	-	-	-
3.Savings over capital formation	-	1.0	25.0	21.1	4.7	0.7	-	-	-
Philippines :									
1.Savings	10.0	2.45	9.7	6.8	7.0	8.4	8.1	6.8	8.8
2.Capital formation	12.3	10.7	8.5	7.5	7.7	8.3	8.7	8.9	8.9
3.Savings over capital formation	-2.3	-8.4	1.2	-0.7	-0.7	0.1	-0.6	-2.1	-0.1

3/ ECAFE Bulletin : P.148, 1957.

The basic financial problem of economic growth involves both the mobilisation of financial resources and the redirection and utilisation of these resources to uses that will contribute mostly to the achievement of the objectives of rising levels of production, employment and income. The resources considered necessary for providing social services to the growing population at a rising standard of living are raised mainly through the fiscal policy of the state. Public outlay is also needed for public services and for providing facilities necessary for stimulating and promoting the growth of private productive activities. As Government competes with the private sector of the economy for the available resources, care need be taken so that whatever resources the public sector or the Government mobilises, would not reduce the resources that would otherwise be available to private enterprise for undertaking desirable productive activities.

In order to meet their increasing financial responsibilities for economic and social services, for investment and current outlays in Government undertakings and financial assistance to the private sector, the Government have to play an active role in mobilising domestic savings. In most of the countries of the region public revenue from taxation and other sources accounts for only a small part of the total national income, and it is essential that steps be taken to increase it substantially. In the underdeveloped countries generally the ratio of central government tax revenue to gross national product is 10 per cent as compared with 25 to 30 per cent or more in a number of economically advanced countries.[4/]

4/ Economic Development and Planning in Asia and Far East : U.N., Vol. IX, No.3, P.26, December, 1958.

Table No.7

The Revenue as Percentage of National Income 5/

(1954 - 55)

India	Ceylon	Burma	Japan	Canada	U.K.	U.S.A.
7.5	17.7	15.0	15.3	17.3	31.0	20.7

This low level of taxation in the region with the exception of centrally planned economy of China-Mainland is due in part to the low level of incomes, but also to the institutional and administrative difficulties in tax collection. If proper measures are taken, it should be possible to increase public revenues substantially without destroying private incentives.

For a rapid economic growth, the Governments in underdeveloped countries cannot depend primarily on voluntary savings. The savings capacity of the lower income group people is low; while the upper income groups spend a large part on luxuries. " The dilemma cannot be solved by exclusive reliance on private initiative.......fortunately, it would be possible to render economic progress independent of the voluntary decisions of individuals by financing investment out of communal or forced savings." 6/

In underdeveloped countries, social values militate against savings. Men act more in accordance with their social values than on any cold calculation of profit or loss. They spend much on jwellery and weddings,etc. 7/ Further, family obligations are ~~xx~~ usually strong so that the need to save for old age is relatively slight, especially

5/ Indian Economy since Independence; H.Venkatasubbiah; P.257
6/ 'Some Theoritical Problems of Post War Foreign Investment Policy' T.Balogh : Oxford Economic Papers : No.7, Pp.93, February-March 1945.
7/ U.N., Mobilisation of Domestic Capital : Pp.190 and 191 Report and Documents of the First Working Party of Experts,1952

in the countryside where formal ownership or the formal tenancy agreement of the family plot will remain probably in the old man's name. The scope of insurance companies except among the gradually growing westernized urban middle class is, therefore, limited. The industrial corporation, whose undistributed profits are so important a part of the savings of all advanced economies, exist only on the fringe in underdeveloped societies. Thus the whole atmosphere in underdeveloped countries is not favourable to savings. The difficulty is not, however, only that people in underdeveloped countries are unwilling to save, it is also that they cannot. Most of these countries have a low level of national income.

In a democratic society, Government as well as the private individual have to share the responsibility of capital formation in an equal measure. The only difference is that their means to acquire capital ~~x~~ assets are different. In most of the underdeveloped countries, Governments are providing an increasing share of their budgets to expenditure on capital projects. Hence the proper financing of such expenditure holds the key to the success of capital formation in other sectors.

In most of the underdeveloped countries in the private sector, capital is formed first, by self-employed farmers and artisans owning their means of production and relying on their own labour and savings for the most part. This group forms the largest sector of productive agents in most underdeveloped countries.

Capital is also formed by the entrepreneures in business, mining, plantations or industry on the basis mainly of money borrowed from other people. In this sector production takes place on a higher scale with hired labour. This sector needs elaborate institutional and legal set up for mobilising the petty savings of millions of people and channelling them for productive uses by a few enterprising persons.

In underdeveloped countries, capital markets are not highly organised. They are not usually suited to the raising of large amounts of capital for big industry. Only part of the wealth in these countries is located in the large cities. In rural areas and in provincial trading centres sources of capital have not yet been sufficiently tapped. Merchants and middleman who finance innumerable small manufactures in Asia are mostly located in small towns or villages. Hence peasants' and craftmen's hoards which would not be available for shares in remote impersonal ventures, can be attracted for local enterprise, which is a part of their daily experience. Small funds can also be accumulated to mutual advantage in local productive cooperatives, which provide capital and work at the same time.

Objectives of Fiscal Policy

Modern taxation has three broad objectives : First, historically comes the crude need to raise state revenue for the costs of administration, war, and for the servicing of debt payments, which may spring mainly from war.

Next, there comes the realization that taxation of this regressive kind is most unfair. A tax should not so fall as to be a higher proportion of the poor man's income than of the rich. So, we come to the modern aim of taxation as a deliberate democratic instrument for leveling the distribution of income and property. The success with which this has been achieved in well-governed parliamentary democracies has surely exceeded the most optimistic hope of the reforms of those days. Together with social services, direct taxation on wealth has in practice been ~~in~~ the chief means of achieving a more equal, a less class ridden, and a juster society.

Finally, the latest major aim of taxation is to secure 'internal stability', i.e., so far as possible to maintain full employment without a steeply rising cost of living. With these three aims

in view, one should look briefly at the main taxes on which the budgets of the underdeveloped countries depend.

Fiscal policies exercise an important influence on methods of financing open to underdeveloped countries. Their objectives may be : either to counteract the inflationary pressure arising as a result of economic progress by reducing overall effective demand; by reducing consumption and non-essential investment, which competes with development programmes. This can be achieved by adopting a policy of differential rates of taxation.

The primary economic objective of the fiscal policy of the government in the modern state is to secure a 'stable progressive economy' where, there is high and stable level of employment, a stable level of prices, and the rate of capital accummulation is sufficient to bring about a steady rise in the standards of living of the masses. The primary purpose of taxation in a growing economy is to restrict private spending to the point, where it no longer exceeds the amount, which given the claims of the state, can be made available.

In the post Korean spurt most of the primary producing countries in the region increased the export taxes and manipulated the exchange rates. This was done to siphon-off some of the windfall gains of the export sector and to impound a large amount of precious foreign exchange.

Role of Fiscal Policy in a Developing Economy

The rate of economic growth depends on the proportion of a community's income devoted to savings and capital accumulation. Communities, which succeed in devoting a high proportion of their income to capital accumulation grow at a faster rate, while others with a lower savings coefficient grow at a slower pace.

Fiscal policies can help the mobilisation of savings by counteracting inflationary pressures and thus establishing more

favourable conditions for voluntary savings, by affecting propensity to consume and save through suitable tax adjustments and borrowing programmes by pruning non-essential expenditure and by encouraging desirable investment through a system of differential rates and tax exemptions. Taxation is perhaps the most effective way of mopping up surplus purchasing power. Under inflationary conditions, therefore, it should be pressed to the highest safe limit. But as ~~w~~ all taxes may not be suitable, their selection should be careful and well thought off.[8/]

Taxation plays an important role in promoting investment in underdeveloped countries by directing unproductive investment into productive channels. If it is properly designed, so as not to adversely affect the economic welfare of the community, it can mop up a large part of the growing income of the masses during the period of economic development and those savings can be canalised for furthering the ecnomic development of the nations.

In a highly developed economy like that of U.S., high average income almost automatically generates a large flow of business and personal savings. There the role of fiscal policy is to minimise the interference of taxation with the incentives to absorb those savings in productive investment. Keeping in view the public expenditure policy, the tax policy is so designed as to minimise the fluctuations in the volume of capital formation and bring about stability in the economy as a whole.[9/]

In underdeveloped countries, taxation can have a more positive role in the process of capital formation and of technological change,

8/. Taxation cannot help to control inflation in an economy which is not predominently monetary. In South East Asian countries, due to their agrarian character of the economy, a great portion of the rural transactions would be out side the scope of taxation. In the cities taxation of staple commodities is much too blunt an instrument to control inflation.

9/ Taxes and Fiscal Policy in underdeveloped countries : U.N.,1954

because of the low levels of income and saving which are the source of capital formation. In these countries the "Level of expenditure depends much more heavily on the ability of the tax system to place the required revenues at the disposal of the Government. Underdeveloped countries are under no illusion that they can or should push their tax ratios of 10 to 15 per cent of national income to the 20 to 40 per cent levels reached in such advanced countries as Austria, Belgium, France, Germany, U.K., and U.S."[10/]

Hence from the standpoint of economic growth it is of great importance to keep under constant study the trend of relationship between taxation and the national income. The more the built-in capacity of a country's tax system is capable of tolerating a rise in the rates of taxation both vertically and horizontally the better is its efficiency for meeting both the public needs arising out of the increased national income as well as for financing a continued increase of it. Below is given the percentage of tax receipts to national income in India since 1951-52 to 1960-61.

Tax Structure

Table No.8

National Income and Tax Receipts

Year	National income in millions of rupees	Total of central and state tax receipts in million of rupees	Percentage of tax receipts of National Income
1951-52	99,700	7,387	7.4
1952-53	98,200	6,778	6.9
1953-54	1,04,800	6,723	6.4
1954-55	96,100	7,204	7.5
1955-56	99,800	7,675	7.7
1956-57	1,13,100	8,917	7.9
1957-58	1,13,900	10,476	9.2
1958-59	1,26,000	10,898	8.6
1959-60	1,28,400	12,199	9.6
1960-61	1,45,000	12,911	8.9

10/ Ibid : P.6

It is clear from the above table that tax receipts have risen considerably in absolute terms during the last ten years, but as percentage of national income the tax receipts have increased to a smaller extent. The rate of growth is not satisfactory in absolute terms when viewed against the increasing role of foreign aid in the financing of India's development in the first two plans.

There is no consistency in the growth of tax receipts. Some years show spurts, while others show comparative stagnancy or even record actual falls. The years 1952-53 and 1953-54 show absolute falls in tax receipts compared with the years 1951-52, while four years show a fall in terms of the percentage of national income taken by taxation. Thus the tax system in India is not showing an element of progression in terms of percentage of national income. The percentage rise is very essential to finance a growing economy successfully and impart to it an element of self-accelaration. This has been so inspite of the very substantial additions, which have been made to the number as well as the rates of taxes during the first ten years of planning. It is thus evident that the tax structure is not sufficiently modulated to meet the needs of economic development.

The target, which the planning commission has set for raising additional taxes to the tune of Rs.1,710 crores even if attained would only mean raising the tax revenue to about 11 per cent of the national income. This surely cannot be considered excessive. We may now refer to some other underdeveloped countries in this respect.

Out of the total cost of Rs.33 crores of the Five Year Plan of Nepal, tax revenue is to account for Rs.7.6 crores.[11/]

11/ Government of Nepal - Draft Five Year Plan - a synopsis Kathmandu : P.13,1956. Also see 'The Economy of Nepal' : Arturo Y. Consing, I.M.F. Staff Papers, P.523; Vol.X,No.3, November 1963.

Table No.9

Proportion of the National Income Absorbed by taxes Accruing to the National Government, Fiscal Year 1959-64, in Philippines 12/

Fiscal Year	National Income	Taxes & Duties	Percentage of Taxes & Duties to National Income
1959	8,325.0	757.51	8.12
1960	9,611.0	854.87	8.89
1961	9,996.5	845.27	8.46
1962	10,381.6	986.24	9.50
1963	10,766.5	1,065.00	9.89
1964	11,151.5	1,115.15	10.00

In Philippines, the bulk of the additional resources that will become available to the Government for financing public projects of the purely Government type is proposed to come from increased taxation. These additional tax revenues will raise the ratio of Government revenues to gross national product from 7.7. per cent in 1957 to about 10 per cent or an average increase of about 1.0 per cent during the programme period. 13/

Table No.10

National Income and Tax Revenue of Ceylon 14/

(Millions of Rupees)

Year	National Income (B)	Tax Revenue (A)	Tax Revenue as percentage of National Income
1947	2288	474.3	20.7
1949	2873	544.1	18.9
1951	4422	776.2	18.0
1953	4352	829.0	19.0
1954	4531	937.4	20.6
1955	5122	1026.6	20.0
1956	4847	1033.1	21.3
1957	5067	1035.0	20.4
1958	5679 (c)	1065.5	18.7
1959	6012 (c)	1124.7	18.7
1960	6340 (c)	1335.2	21.0

12/ The President's Budget Message to the Fourth Congress of the Republic of Philippines - Five Year Fiscal Plan 1960-64 and Fiscal Year 1961 Budget - Manila ; P.75, Annex.G,1960

13/ Three Year Programme of Economic and Social Development 1959-60 to 1961-62 : PP.37,38 : January 2,1959, Manila, Philippines.

14/ (A) Central Bank of Ceylon - Annual Report, 1960,Table No.20
(B) ECAFE -Annual Report, 1958, P.176
(C) Central Bank of Ceylon,Annual Report, 1960, P.30,Table No.II.6

The tax structure of underdeveloped countries differs from that of advanced countries. In the former, indirect taxes contribute more to the total tax revenue, while direct taxes contribute a smaller amount to the total tax revenue in countries of the latter category. This is because of the fact that most of the countries of the region, leaving aside China Mainland where the Government relies more on the profits of the Government operated enterprises rather than on the tax revenue, are countries whose exports consist of primary produce and whose imports consist mainly of consumer goods. Secondly, due to the glaring inequalities in income there are only a few persons who are capable of paying the taxes and the bulk of the people remain outside the scope of taxation. Besides, the agrarian nature of the economies leaves little scope for raising more through direct taxes. Below is given an account of direct and indirect taxes as percentages of total tax revenue in the countries of the region :-

Table No.11

Direct and Indirect Taxes as Percentage of total tax Revenue in the Region. 15/

Country	Year	Direct Taxes	Indirect Taxes: Customs Duties	Indirect Taxes: Other Taxes
British Borneo	1950-RE	Negligent	17	83
Brunei	~~1951-RE~~	~~9~~		
North Borneo	1951-RE	9	87	4
Sarawak	1950-RE	1	92	7
Burma	1950-51 RE	13	33	54
Cambodia	1951-	13	71	16
Ceylon	1950-51	19	71	10
China (Taiwan)	1951	33	24	43
Hong Kong	1949-50	36	-	64
India	1951-52	28	52	20
Indonesia	1951	15	18	67
Laos	1951	17	80	5
Japan	1951	59	1	40
Malaya	1951	14	80	5
Pakistan	1951-52	14	64	22
Philippines	1950-51	22	6	72
Singapore	1951	42	-	58
Thailand	1951	5	35	60

15/ U.N., Mobilisation of Domestic Capital : P.39, Sales No. : 1953,II.F.4 Also see Appendix 'A' Table No.2

In Japan, in 1951, about 59 per cent of the tax revenue was raised through direct taxes. In other advanced countries also a considerable proportion of the tax revenue is raised through direct taxes (see table No. II, Appendix 'A')

<u>Direct Taxation</u>

There are a few underdeveloped countries of the region in whose fiscal systems income taxes play a predominent part. Japan, though not an underdeveloped country, is the only one which raises more than half of her tax revenue in this way. India comes next on the list. Nowhere in the region the income tax has succeeded in capturing more than 3 per cent of the annual national income. In 1950-51, the yield from income tax as a proportion of the national income was less than 2 per cent in India. In Burma, it was 1.3 per cent ; in Ceylon, it was 3 per cent, while in Malaya, Philippines, and Thailand, it was one per cent, 1.2 per cent, and 0.6 per cent respectively. This is in contrast with the 10 to 15 per cent typical of more advanced countries.[16/]

" In Burma, 1953, a man with wife and three children had to earn over 20 times the national per capita income before he paid any tax on income. In India (1950), the limit was 11 times the <u>per capita</u> income, while in Ceylon and Philippines, in 1953, the limit was 14 times. In Japan, it was 2.6 times, U.K., 106, U.S. 1.4, Austria 1.0, and Canada, 1.9 in 1953.[17/] When the rates of income taxes of the various countries are compared, we see that India's rates of taxes relating to the range of income from £ 2,000 (Rs.26,666) to £ 10,000 (Rs.1,33,333) are higher than the corresponding rates in Ceylon, Philippines and Pakistan. Indian rates approximate those of Burma and are substantially lower than those in Japan.

16/ Public Enterprise and Economic Development : A.H.Hanson :P.75

17/ Ibid : P.76

Table No.12

International Comparison of the Incidence of Income Taxes: Taxation of Personal Earned Income-Married Individual with two children (Tax as Percentage of Income) 18/

Income in Rupees	India Rupees	Burma Kyat	Pakistan Rupee	Ceylon Rupee	Japan Yen	Philippines Pesos	U.K. £	U.S.A. Dollar	Canada Dollar
13,333	7.1	5.7	5.7	4.8	26.6	1.2	6.8	2.9	3.5
26,666	17.3	15.7	15.2	12.6	37.3	5.9	19.6	11.9	10.5
40,000	28.6	27.1	26.0	19.6	42.9	11.0	26.6	14.8	13.9
53,333	37.1	34.9	32.5	25.5	46.9	14.2	32.2	16.8	17.0
66,666	43.5	40.5	38.2	31.7	49.6	17.0	37.5	18.7	20.3
80,000	48.7	45.1	43.1	36.6	52.0	19.2	41.9	20.5	23.4
93,333	53.1	48.7	47.3	41.3	53.9	21.5	45.7	22.1	26.2
1,06,666	56.9	51.7	51.1	45.7	55.2	23.3	48.8	23.6	28.3
1,20,000	60.1	54.1	54.5	49.5	56.3	25.2	51.6	25.2	30.0
1,33,333	62.9	56.5	57.2	52.7	57.2	26.8	54.0	26.7	31.7
2,00,000	72.3	65.0	67.8	63.5	59.8	32.5	65.1	34.2	37.4
2,66,666	77.2	70.8	71.9	68.9	61.2	36.9	72.0	40.1	41.3
3,33,333	80.1	75.2	75.1	72.1	61.9	40.0	76.0	44.7	44.5

18/ Taxation and Foreign Investment; National Council of Applied Economic Research, Delhi, PP.22-24, 1957

The narrow scope of personal income taxation in underdeveloped economies stems from the fact that the majority of the people lives at or even below the subsistence level, that many are outside the money economy and, finally that there is a general lack of literacy.

Indian tax system is notable for its income tax structure, which is one of the most progressive in the world as also for its progressive Expenditure, Gifts, and Wealth taxes and Estate Duty. . The income to which these taxes are applicable is primarily that in the organised sector of the economy-modern industry, commerce, and services - and it has been rising faster during this period than the national income as a whole. But direct taxes are declining in their proportionate importance over a period of rising national income.

Table No.13

Composition of tax receipts in India

(Millions of Rupees)

Category	First Plan Period		Second Plan Period		Ten Years 1951-52 to 1960-61	
	Tax Receipts	Percentage of total tax receipt	Tax Receipts	Percentage of total tax receipt	Tax receipts	Percentage of total tax receipts
Taxes on income and property	12,347	34.5	17,433	31.5	29,780	32.7
Taxes on commodity and services	21,104	59.0	34,630	62.6	55,734	61.2
Taxes on transaction	1,425	4.0	1,960	3.5	3, 385	3.7
Other taxes	885	2.5	1,332	2.4	2,217	2.4
TOTAL	35,761	100.0	55,355	100.0	91,116	100.0

It is clear from the table that taxes on income and property have not increased in importance during the last ~~tax~~ ten years. On the other hand their comparative position has declined. But, it is only direct taxation that can have rates varying with the ranges on income and wealth and, therefore, contains a built-in-element of elasticity that can show a progressive response in terms of tax receipts to increasing national income.

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Taxation is perhaps the most effective way of mopping up the surplus purchasing power under inflationary conditions, it should be pressed to the highest safe limit, but as all taxes may not be equally suitable, they should be carefully selected. Direct taxation is increasing in importance in underdeveloped countries, but the limit seems to have been almost reached in India and Pakistan.[19] However, the Governments of underdeveloped countries should be concerned with the potentialities of personal income taxation as a means of strengthening equity and as an important source of revenue. As the economy of a country becomes diversified, the scope of its tax pattern must be so enlarged as to include all business activities. Hence care must be taken to allow for a system which covers corporate as well as non-corporate business. One of the most important and the greatest need of the time is to improve the administrative techniques of collecting taxes.

There is a growing realisation that conditions within which the most modern, equitable and flexible instruments of taxation thrive do not yet prevail in most of the underdeveloped countries, and that substantial modifications of the fiscal techniques prevailing in developed countries are necessary to be adopted to the underdeveloped countries.

19/ Mobilisation of Domestic Capital : Report and Documents for the First Working Party of Experts, U.N., ECAFE, 1962, P.66 (Sales No. : 1953, II.F 2)

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A continuous and rapid growth of the money economy is the first prerequisite for the modernization of the tax system of underdeveloped countries. The subsistence farmer cannot be satisfactorily ~~##~~ reached by an income-tax, because a greater part of his real income cannot be satisfactorily assessed. Further, due to widespread illiteracy, a majority of the people is unable to fill in the simplest income tax return. Keeping of proper accounting records honestly and reliably is another prosaic but important condition for satisfactory income taxation. In most of the underdeveloped countries, a number of small businessmen and traders do not keep accounts and even those who keep such records have faulty accounts. Vigorous tax administration combined with widespread educational compaign can do much to improve accounting standards.

Another requirement for satisfactory income taxation is a large degree of voluntary compliance on the part of the tax-payers. It is fairly clear that such spirit does not grow up overnight. A long period of popular education and efficient and equitable administration of these taxes that can actually be endorged seems necessary to establish firmly the habit of general voluntary acceptance of the fiscal responsibilities of citizenship. However, it should not be forgotten that " taxation is itself an instrument of social change. It does not need to wait passively until restrictive and binding social institutions are changed, but can itself help hasten the change. For example, a tax reform which changes the relationship between landlords and tenants can be the beginning of an overall land reform. Effective progressive taxes also can have significant distributive affects which will influence not only financial relationship, but the social structure as such."[20/]

20/ U.N., Taxes and Fiscal Policy in Underdeveloped Countries, P.22, 1954.

Indirect Taxes

In most of the underdeveloped countries of Asia leaving aside India and Pakistan, where owing to the development of the redistributive aim, direct taxes play a fairly important part, indirect taxes are very important and the amounts thus raised are still a large proportion of the total tax revenue. It is because they are the primary exporting countries and depend much on agriculture or extractive industries.[21] However, indirect taxation covers various tax means which differ greatly as to their applicability and effectiveness in these countries.

A majority of the underdeveloped countries of Asia are raw material producing countries and rely on export duties as a major source of Government revenue. Since the proceeds vary automatically with exports, export duties are potential automatic stabilisers of internal activity. The stabilisation effect is greater with an ad-valorem tax than with a specific tax, because the proceeds vary with the price as well as with the volume. However, the ability of the Government to cope with the problems of stabilisation as well as to promote economic development depends largely on the fiscal and monetary treatment of export price fluctuations. Where Governments have already instituted export taxes, differential exchange rates, or other devices bearing directly on commodity exports, a rise of export prices can be expected to bring automatically an increment in Government revenue. This effect will be enhanced, if in addition the authorities act promptly to raise the rates in question, or have forehandedly established a sliding scale of rates. " Malaya applied sliding scale tax to rubber, which taxes an increasing proportion of the value of exports as their prices rise.[22] The jute export duty in India in and after 1951 is another instance on the point.

21/ See table I, page 3

22/ Theory Practice Policy - International Economics, Behrman and Schmidt.

Where Governments rely largely or wholly on general taxation, the revenue affects of an export price boom are more uncertain depending on the diffusion of income increases through the economy and on the scope and effectiveness of the whole network of taxation. In an underdeveloped country, where increases in income are often concentrated and easily concealed, the progressive income tax is limited in its effects, and those effects are belated. Stepped up excise taxes are more enforceable but are undesirable, regressive, and sometimes are perverse in extending the inflation they were designed to prevent. The Government's ability to utilise its incremental revenues for developmental projects is limited by the cyclical origin of these revenues. The outbreak of the Korean War brought fabulous export earnings to many a primary producing countries as a result of the feverish purchasing, partly by Governments for rearmament and stockpiling and partly by private business in anticipation of future price increases. From the first half of 1950 through the first half of 1951, foreign exchange earnings of all primary producing nations rose by over 50 per cent. A number of Governments imposed additional taxes on exports to siphon off the increased income. But the boom came and went so quickly and the Governments were slow to act that the taxes diverted only a small portion of the flood earnings into Government coffers. Malayan export duties seized only 8 per cent of the increments in rubber and tin export earnings during the boom, and Indonesia taxed away sums equivalent only to 14 per cent of the increase in total earnings.[23]

Since consumption taxes often bear most heavily on the poor and middle classes who by virtue of their numbers do most of the spending, variations in consumption taxes can be an effective means of

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23/ Ibid : P. 235

controlling domestic expenditure. Moreover, consumption taxes have a selective feature, which increases their usefulness x in discouraging luxurious expenditure and thus diverting investment to productive purposes. Besides, certain consumption taxes e.g., a heavy excise duty on narcotics has social effects also.

Revenue from sales tax has considerably increased between 1951-52 and 1960-61 in India. In the field of central taxation, the revenues raised through customs are of uncertain nature. While the revenues raised through import duties have shown great fluctuation, the revenues through export duties have shown a considerable and steady decline.

Table No.14

Tax Revenue raised through Customs and Excise Duties 24/ in India between 1950-51 to 1960-61

(Rupees in Crores)

	1950-51	1955-56	1960-61	1961-62	1962-63 (Revised)	1963-64 (Budget)
Imports	107.70	127.98	154.61	198.22	224.32	306.64
Exports	47.36	37.76	13.12	12.69	9.33	3.95
Total of Customs	155.06	165.74	167.73	210.91	233.65	310.59
Union Excise Duties	67.54	145.25	416.35	489.31	553.69	700.17

In 1950-51, import duties accounted for Rs.107.7 crores and rose to Rs.198.22 crores in 1961-62, and according to the 1963-64 budget, they are estimated to account for Rs.306.64 crores. In 1950-51, export duties accounted for Rs.47.36 crores and the corresponding figure for 1963-64 budget is Rs.12.69 crores. Thus in future the revenue from customs may continue to decline with the substitution of domestic products for imports. Contrary to this, excise duties have registered a phenomenal increase from Rs.67.54 crores in 1950-51 to about

24/ Report on currency and finance, 1962-63 statement 48, P.590 Reserve Bank of India.

Rs.489 crores in 1961-62 . The corresponding figure for 1963-64 budget is Rs.700 crores. Therefore, in India, where the need of resources is so urgent and vast and x where obviously the scope for raising additional revenue from direct taxes is limited, reliance on indirect taxation is certainly not unjustified. Further, the necessity to impose indirect taxes follows from the very structure of our economy. As a result of the preponderance of the agricultural sector low per capita income and a large unorganised sector with millions of self-employed persons, the greater part of the national income in almost all the underdeveloped countries escapes direct taxation. Besides, a large mass of incomes in these countries to-day may be described as wage earner's incomes, a direct tax on which presents grave administrative problems. The only way in which this broad base can be used for taxation is to rely more on indirect consumption taxes.

An important function of taxation in a developing economy is to keep down consumption to the limits set by the claims of investment. Both direct and indirect taxes tend to reduce consumption, the one by reducing the disposable income of the consumer, and the other by reducing the quantity of goods offered in exchange for given consumption expenditure. But direct taxation curbs the consumption of only a small fraction of the masses. The great bulk of domestic production is consumed by the non-income tax paying masses and the consumption of these overwhelming numbers can be influenced only through taxing consumer goods.

Indirect taxation does not weaken incentive. It is more difficult to evade and easier to administer. It is a valuable instrument of planning, because it can be used to discourage the consumption of particular commodities. But if it is pitched too high, it can set up a chain reaction of rising prices and wages. The main objection, however, is that given unequal distribution of incomes, it

burdens the poor more than the rich. The yield of direct taxes, even if they become stiffer and more diversified and even if avoidance and evasion are minimised, is not likely to be sufficiently large for the nation's needs. Thus, the exigency of raising resources for the third plan clearly requires a sufficiently wide base of taxation provided by indirect taxes.[25] Indirect taxes have to be given an important place in the fiscal mechanism of an underdeveloped country in order to remove the bad effects of direct taxation due to the prevalence of high degree of skewness of income distribution.

To check the regressive nature of indirect taxes, they should be so levied as to fall upon the relatively well to do classes of people by taxing semi-luxury and luxury consumption steeply.

Capital formation is the pre-requisite for economic development. But in an underdeveloped country, private capital formation is insufficient to bring about a desirable rate of economic growth. Therefore, compulsory saving is advocated.

The underdeveloped countries can increase the proportion of their national income taken by taxation without unduly disturbing the economy and perhaps even with positive gains in the face of the inflationary pressures. The taxes should be so levied as to tap funds that otherwise would have gone into such channels as luxury consumption or socially unproductive investment. "The proceeds of the compulsory saving are not a net addition to the supply of capital. To regard them as such is to ignore the possible, and indeed likely, reduction in private capital formation which results both from the transfer of funds and from the disincentive effects of taxation. The overstatement of the increase in the supply of capital is highly probable and it is quite possible for compulsory saving to result in a reduction in total

25/ The Tax Gatherer's Dilemma : Dr. B.N.Ganguli; P.25, The Illustrated Weekly of India; August 13, 1961

investment.[26] Therefore, taxes should not be levied simply with the aim of displacing private productive investment and essential consumption. This can be possible through a careful enquiry into economic characteristics, social and cultural institutions, and prevailing standards of tax administration.

Compulsory saving may prove to be very productive when the funds are used for the provision of basic communications, education or agricultural extension work.

In a developing economy, for securing economic stability, first, such taxes should be chosen, which may yield the maximum possible revenue. Second, tax should impinge just where inflationary pressure is arising so that it can be kept under control. Fiscal policies are expected to promote economic stability by counteracting and controlling inflationary pressures arising from economic growth. Indeed, even the most carefully planned and prudent development programmes have inflationary concomitants. Fiscal policy should be, therefore, so designed as to reduce overall effective demand, establish conditions in which anti-inflationary methods of financing, especially voluntary savings as well as foreign capital may be employed. Finally, taxes should be such, which may aid and stimulate the development programmes. They should not be a hinderance in the process of economic growth. They should be geared in such wise that they encourage people to invest.

In underdeveloped countries, the tax policy should be so adjusted as to set free productive resources for investment in the private sector. Its main aim should not be to bring about an equal distribution of wealth. If this will be the main aim of tax policy then a large part of the community's income will go in consumption rather than in prodiction and the policy shall be a self-defeating one.

26/ Economic Analysis and Policy in Underdeveloped Countries : P.T.Bauer : P.118, 1957

As the incomes of the lower strata of the society are very low, their propensity to consume is very high, therefore, a slight rise in their income would lead to a greater consumption and very little would be left for saving. On the other hand, taxation reduces the income of the higher strata of the society and thus reduces their capacity to save. Therefore, in an underdeveloped country the income of the poor should be raised by increasing their productive power.

Voluntary Savings

In underdeveloped countries there are substantial amounts of sterile capital hoarded away from utilisation in the production of goods and services. Gold hoarding and investment in jewellery and land in South and South East Asia are deep rooted habits of all sections of the population. Due to the nature of the hoarding, it is difficult to assess the potential financial contribution of the people to the needs of current national production. This wealth can be of considerable importance in the development financing and the problem of raising resources for development financing could be eased to a great extent, if these hoardings are mobilised. But it should not be forgotten that a long term development programme has to rely on large recurrent contributions from current income. Since savings depend on income, and income being low in these countries, the proportion of voluntary savings to total financial need of the Governments is very low, except in India. In the First Five Year Plan of India, voluntary savings accounted for Rs.509 crores of about 26 per cent of the total plan public expenditure of Rs.1960 crores. During the Second Plan of India, voluntary savings accounted for about 25 per cent of the plan expenditure, while during the Third Five Year Plan, they are expected to account for Rs.1,400 crores or 19.3 per cent of the total plan public expenditure of Rs.7,500 crores. Small savings are to account for Rs.850 crores, while loans from the public are to account for Rs.550 crores. Thus, the targets

set for the Third Plan are, ~~though~~ higher in absolute terms than those of the Second Plan, but when seen as percentage of the total public plan expenditure, they are much lower. Therefore, vigorous efforts shall have to be made to raise more resources through voluntary savings.

It is suggested in the Second Five Year Plan of Pakistan that Rs. 1,500 millions should be raised through public borrowings during the Plan period. The Government should seek to obtain as much of the public loans as possible from non-bank investors, i.e. private investors, insurance companies and savings institutions. The balance should be raised primarily from commercial banks and only in the last resort from the State Bank.27/

In the First Five Year Plan of Nepal, voluntary savings accounted for Rs.2.6 crores or 8 per cent of the total plan expenditure of Rs.33 crores.28/

Table No. 15

Receipts through Net Domestic Borrowing Government by Ceylon 29/

(In Millions of Rupees)

Year	Total Receipts	Domestic Borrowing			Net Domestic Borrowing as percentage of total receipts
		Net market borrowing	Net Administrative Borrowing	Total Domestic Borrowing	
1947-48	592.9	33.8	-2.1	31.7	5.3
1950-51	968.5	80.2	42.1	122.3	12.6
1953-54	1,021.2	-94.0	-9.0	-103.0	-
1956-57	1,506.0	166.3	5.5	171.8	11.3
1959-60	1,862.4	327.6	68.9	396.5	21.3
1960-61	2,004.7	406.5	35.5	442.1	22.0
1961-62	2,098.3	336.0	104.5	440.5	21.0
1962-63 (Provisional)	2,007.0	331.6	-27.9	303.6	15.1
1963-64 (original estimates)	2,255.2	227.8	25.0	252.8	11.2

27/ Outline of the Second Five Year Plan of Pakistan,1960-65, P.22,January,1960

28/ Draft Five Year Plan a Synopsis, Government of Nepal, P.13, Kathmandu,1956.

29/ Central Bank of Ceylon Annual Report for the year 1963, Table No.20

The above table shows that the position of voluntary savings has not been satisfactory in Ceylon also. Revenue raised by way of net domestic borrowing has fluctuated between Rs. -103.0 million in 1953-54 and Rs.406.5 million in 1960-61.

Table No.16

Public Borrowing and Total Revenue in Philippines between 1960-62 30/

(Million Peos)

Source	1960	1961	1962	1961-62
Total revenue	430.6	433.4	435.0	1,299.0
Public Borrowing	70.0	80.0	90.0	240.0
Percentage of Public Borrowing to total revenue	16.2	18.4	20.5	18.4

Table No.17

Public Borrowing and Total Revenue in Philippines between 1957-61 31/

(Million Pesos)

Source	1955 Actual	1956 Esti-mated	1957	1958	1959	1960	1961	Total 1957-61
Total Expenditure	847	1,039	1,209	1,285	1,366	1,453	1,545	6,858
Public Borrowing	78	140	94	101	102	115	127	539
Other Bond Issues	-	-	19	19	19	19	19	95
Other Public Borrowing	72	48	6	6	6	6	6	30
Total Borrowing	150	188	119	126	127	140	152	664
Percentage of Borrowing to total expenditure	17.7	18.0	9.8	9.8	9.4	9.6	9.8	9.6

In Philippines, the total internal borrowings accounted for only 9.6 per cent of the total Five Year Plan expenditure of Pesos 6,858 million between 1957-61

30/ Three Year Programme of Economic and Social Development FY 1959-60 to 1961-62: P.37,National Economic Council,January 2,1959, Manila,Philippines.

31/ The Five Year Economic & Social Development Programme,1957-61, P.72,January 3,1957,Manila Philippines.

Though public finance plays a very important role in mobilising domestic capital in underdeveloped countries, the importance of voluntary savings should not be neglected. Economic growth depends on the level of investment, which in turn depends on the rate of savings. The larger the rate of investment, the greater is the rate of economic growth. Under free enterprise the rate of saving is mainly determined by the dicisions of the individuals as to how they allocate their income between consumption today and savings for the future. But now the state has attained the right and assumed the duty of making and implementing on behalf of the community the most fundamental of economic choices, viz., the distribution of productive resources for determining the rate of growth of the community's real capital.

The significance of savings varies greatly depending on the circumstances of the economy in question. In an underdeveloped area where the rate of saving is low and capital scarce, the provision of additional savings may well be essential if development is to proceed. In underdeveloped countries, apart from the willingness of private persons to make investments, if they could find the finance, Governments are overwhelmed with projects for spending on roads, water supplies, flood control, irrigation, electric power, factories, schools, houses and hospitals etc. What restraints this investment is not the lack of demand, but simply the lack of saving to finance it. In these countries, it would be possible for decades to maintain fruitful programmes of public investment of say 12 per cent net of national income, but the people are willing to save only 4 or 5 per cent.[32] Measures to increase such savings lie in the direction of developing savings institutions, of propaganda, and of financial incentives. There is a whole range of savings institutions that can be developed. The amount of savings depends on how widespread these facilities are. Saving is a habit

32/ Theory of Economic Growth : W. Arther Lewis; P.216.

which is no doubt guided by the psychology of the person, but the propensity to save can be increased by making the psychology more favourable to ~~the~~ savings through ~~a~~ propaganda.[33/] In the post-war period most of the Governments in the region have taken various steps to encourage voluntary savings.

Forms of Voluntary Savings

The modes of stimulating voluntary savings vary from community to community. In Singapore, the post office savings bank started operations as a separate entity in January 1949. At the ~~t~~ end of 1951, there were 10,351 depositors, an increase of 27.4 per cent over 1950. The total amount deposited in 1951 was M.$ 35.3 million, which compared with M.$ 28.3 million in 1950.[34/] The Government initiated an intensive savings compaign on 21st July,1951. Other measures adopted to encourage savings included the introduction of mobile vans for providing savings facilities in the rural areas. In Burma, voluntary savings amounted to Rs.79.4 million at the end of December 1951. Compared to Rs.44.6 million as at the end of 1948, the rate of increase in recent years is rather high. Of course, as a ~~x~~ percentage of national income it is very low. The increase of annual average voluntary institutional savings, if compared to gross national product, which is estimated at Rs. 2.949 million for the year 1950, corresponds to only 0.4 per cent. Private savings are extremely small if compared to figures of public savings.[35/] In Thailand, the total of time deposits of banks and savings bank deposits increased at the annual rate of 10 per cent both in 1950 and 1951. This increase corresponds to only 0.2 per cent of gross national product. The demand deposits of banks increased by a much faster rate. In 1950, the rate of increase in demand deposits was 41 per cent, while in 1951, it was 27 per cent.[36/]

33/ Ibid; P.229
34/ U.N.Mobilisation of Domestic Capital : P.51, Sales No.1953,II.F.4
35/ Ibid : P.54
36/ Ibid : P.56

The following table shows the growth in small savings in India from 1950-51 onwards [37/]

Table No.18

Year	Amount in Crores of Rupees	Year	Amount in Crores of rupees
1950-51	33.52	1959-60	82.91
1955-56	66.51	1960-61	103.77
1956-57	58.95	1961-62	87.75
1957-58	69.46	1962-63 (R)	85.00
1958-59	78.21	1963-64 (B)	105.00

Table No.19

Liabilities of Scheduled and Non-Scheduled Banks in India [38/]

	1951-52	1955-56	1960-61	1961-62	1962-63
Indian Scheduled Banks Business in India					
Time Liabilities	238	356	962	1024	1062
Demand Liabilities	435	503	724	795	879
Foreign Banks Business in India					
Time Liabilities	43	59	131	148	159
Demand Liabilities	132	132	116	119	122
All Scheduled Banks Business in India					
Time Liabilities	281	415	1074	1173	1222
Demand Liabilities	567	635	841	915	1002
Non-Scheduled Bank Business in India					
Time Liabilities	26	42	35	31	27
Demand Liabilities	13	23	13	13	9
State Cooperative Bank Maintaining Accounts with the Reserve Bank of India					
Time Liabilities	10	16	37	36	41
Demand Liabilities	10	12	25	29	30

37/ Prepared from statement 50, Annual Report, on Currency and Finance, Reserve Bank of India, 1962-63, Statement 50, P.S94

38/ Prepared from Reserve Bank of India Bulletin, February 1964 PP.190,192,194 and 198

The above table shows that the aggregate deposits of all Scheduled banks in India rose from Rs.848 crores in 1951-52 to Rs.2,224 crores in 1962-63. This indicates a developing habit of savings amongst the people. India thus has a comparatively well-developed financial market. The different techniques of borrowing resorted to in some of the highly developed countries are being utilised here. The Government is trying to devise a diversity of securities to suit the preferences of different classes of investors with respect to denominations, maturity and yield.

The contribution of non-bank investors to public loans in Pakistan has been small except in the case of two loans floated in July 1959. This contribution was only 15 per cent of the outstanding public debt of Rs.2,620 million on 30th June, 1959. However, the two loans floated in July 1959, met with a better response; the non bank contribution being Rs.95 million or 25 per cent out of a total subscription of Rs.372 million. This resulted from a combination of several factors, including a higher interest rate on public loans, excess liquidity in the market, and increased confidence in the Government. If a determined effort is made, it may be possible to raise as much as Rs.500 million of subscription to public loans from non-bank investors.[39/]

In Pakistan, from the end of 1949 to the end of 1951, time deposits outstanding with banks increased from 205 million to Rs.282 million. During the same period post office savings, including certificates, increased by Rs.44 million and the outstanding paid up capital of joint stock companies increased from Rs.131 million to Rs.242 million. The annual increase of institutional savings is roughly estimated at about 0.5 per cent of national income.[40/] The Government of Pakistan also operates a small savings scheme in the form of 12 year National Savings Certificates and six year defence saving certificates.[41/]

39/ Outline of the Second Five Year Plan (1960-65) Government of Pakistan, P.22, January 1960.

40/ U.N.Mobilisation of Domestic Capital : P.56, Sales No.1953, II.F.4

41/ Mobilisation of Domestic Capital; U.N., P.68, -1952, Sales No.1953 II.F.2

In Ceylon, for the last decade the savings habit in the general public is becoming more and more widespread. The deposits in the Post Office Savings Bank, which accounted for Rs.103.5 million in 1946 have risen to Rs.362.3 million in 1962. The provisional figures put for the year 1963 are Rs.368.5 million. The deposits in the Ceylon savings bank and the commercial banks stood at Rs.75.4 million, and Rs.426.4 million respectively in 1962 contrary to Rs.60.9 million and Rs.61.0 million in 1946. However, savings certificates have not proved successful and the amount thus raised is much too small. In 1948 it accounted for Rs.33.2 million. Thereafter, it came down to Rs.24.8 million in 1955. In 1962, it has again risen to Rs.32.9 million. Therefore, hectic efforts shall have to be made to make these schemes more popular in order to mobilise more domestic resources in this way.[42/]

In Philippines, deposit liabilities of other banks aggregated pesos 1,661.6 million at the end of December, 1959. This showed an expansion of Pesos 154.9 million or 10.3 per cent during the year outpacing the Pesos 133.4 million or 9.7 per cent growth registered during the preceding year. The main increment occurred in the savings and time deposits of private entities, followed by the savings and time deposits of semi - Government entities. As a whole, total savings and time deposits reached a new height of Pesos 885.4 million, up by Pesos 119.7 million or 15.6 per cent during the year 1959, while demand deposits accounted for Pesos 776.2 million, up by Pesos 35.2 million or 4.8 per cent. The rates of increment in 1958 were 15.4 per cent and 4.4 per cent respectively.[43/] The public borrowing through the issuance of bonds shall tap a yearly average of Pesos 818 million from Government financial institutions, including the G.S.I.S., S.S.S., D.B.P., Private Financial institutions, private individual, and other sources.[44/]

42/ Central Bank of Ceylon Annual Report for the year 1963, Table 16

43/ See table III and IV, Appendix 'A'

44/ Three Year Programme of Economic and Social Development (1959-60 to 1961-62); Adopted by the National Economic Council P.5, January 2, 1959, Manila, Philippines.

Conclusion

The act of saving is an individual, not a collective one. That is why individual savings, even when given the greatest encouragement by public financial policy, are incapable of bringing the economic development to the take-off stage.45/ The real impediments in the way of mobilisation of rural savings are the general ignorance, illiteracy and the conservatism of the rural population and its consequent lack of bank mindedness. The over cautiousness of the postal authorities and the harshness of the subordinate staff also act as a deterrent. It is only when the dark ignorance of the rural masses is dispelled that sustained improvement in the situation may be expected. In the meantime effective publicity measures should be adopted to educate the rural population in banking habits.

Savings drives must be directed towards people in the lower income groups and in the villages, who may be saving less than they might if given better incentives and opportunities. Stress must be laid on the provision of ~~places~~ institutions where small savers can deposit their money, on security, and on the satisfaction of their almost invariable demand for high liquidity. The effect of savings institutions on the amount of savings mobilised depends on their number, working accessibility and the interest rates they pay. If the working of the savings institutions is improved and somewhat higher rates of interest are allowed, savings will probably be stimulated. In this direction India has had some success and there are reports of progress in Pakistan.

A further success in the field of mobilisation of personal savings depends on an improvement in standards of honesty, competency and understanding among the masses.

45/ Public Enterprise and Economic Development : A.H.Hanson : P.58

Efforts should be made to develop cooperative institutions for the purpose of attracting savings. In spite of great efforts, the cooperative movement in the region has not been successful. First, it is because of the low level of incomes and savings. Second, it is due to the inadequate realisation by the people of the aims and principles of cooperation, the undue emphasis laid on the dispensing of the credit, and the lack of the interest of the wealthier rural classes in the cooperative movement.

For encouraging rural savings "cooperative debentures are intended to meet this end. These rural debentures should be, as for as possible, for specific projects of development in which the villager is interested."[46] Cooperative banks can help considerably in mobilising rural savings provided they are organised on efficient lines and enjoy the confidence of the rural population. Besides, savings can also be mobilised by organising and operating mobile savings vans in the underdeveloped countries to provide greater facilities for saving in the rural areas. This is being done in Singapore.

Collective or cooperative saving is another way of mobilising savings. In Great Britain and Israel, trade unions and other professional organisations have often used their considerable moral and economic standing to accumulate funds and invest them in ~~x~~ new economic and socio-economic ventures. This method of carrying out development projects has considerable chances of success, because it is based on the unity and loyalty of the members, who frequently respond whole heartedly to the appeal. Further, it utilises the saving potential of a large,

46/ The General Report of the Committee of Directors All India Rural Credit Survey, 1955, P.267

well organised association and directs it into specific channels of investment.....Impressive housing developments, rural settlement projects, industrial enterprises and even health and educational institutions have been created and financed with the framework of such organisations.47/ This method can also be utilised in underdeveloped countries like India.

Insurance Companies play a very minor role in mobilising domestic savings in underdeveloped countries. Therefore, it is necessary to stimulate insurance business so as to mobilise larger middle class savings. Thus, compulsion may be exercised by asking Government and semi-Government employees to get themselves insured within certain prescribed limits. In the mean time postal life insurance facilities be extended to a still wider area and even to the general public. Further, to increase national savings a compulsory national provident fund scheme for persons employed in private institutions should be fostered. Such funds would not only add to the savings available for development but also provide social security. " In Malaya, legislation had been passed making it compulsory for all employees earning upto Malayan dollar 400 per month to contribute to the National Provident Fund. It is estimated that when the scheme is fully established the Fund will obtain ten times as much as the savings deposits now held in Malaya. In Ceylon the proposed National Provident Fund Scheme envisages a five per cent contribution each by the employee and the employer."48/

Development bonds or certificates are a normal and desirable method of channelling private savings into the financing of the country's basic development. Compulsory savings among Government

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47/ Studies in Economic Development; Alfred Bonne : P.212

48/ Mobilisation of Domestic Capital : Reports and Documents of the First Working Party of Experts : U.N.,1952,P.15(Sales No.1953, II.F.2)

employees, with assurance of a reasonable return in interest, can contribute significantly to the development fund and give to Government personnel a direct stake in the success of the Five Year Plan. Such savings must be preceded, however, by such salary increases as are necessary to fundamental security, dignity and efficiency in Government service. Greater emphasis should also be placed on increased sales of Government bonds to private individuals. It will take time, however, before private individuals purchase Government bonds on a substantial scale. Even in India, which has the most developed capital market in this area, only a very small portion of the Government securities is held by private individuals. In Thailand, perhaps only a little more than " one per cent of the Government bonds is held by private individuals." 49/

Further, as the public is not used to buying Government bonds, great attention must be given to increasing savings and time deposits with various institutions, which in turn would be able to invest their funds in Government bonds. More branches of commercial banks and postal savings banks should be opened in villages and cities.

Vigorous educational campaign for savings should be carried out with the help of the savings ~~commodities~~ media including organisations of savings groups, holding of savings weeks, savings rallies and competitions etc. In Ceylon, " The Government has been selling savings stamps since February 1949, which have been increasingly popular, especially among school children and estate labourers. 50/ This method should also be resorted to in other underdeveloped countries with a view to create the habit of savings among the students and labourers.

Most of the underdeveloped countries have rural overpopulation and thus the economies are characterised by chronic and large-scale under employment in agriculture. This state of " disguised unemployment implies

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49/ Ibid : P.83, U.N.1952 (Sales No.1953, F.2)
50/ Ibid : P.51, U.N.1953 (Sales No.1953,II.F.4)

at least to some extent a disguised saving potential as well ....As things are, the unproductive surplus labourers on the land are sustained by the productive surplus labourers. The productive labourers are performing virtual saving; they produce more than they consume. But the saving runs to waste, the saving is abortive; it is offset by the unproductive consumption of the people who could be dispensed with, who contribute nothing to output. If the productive peasants were to send their useless dependents to work on capital projects and if they continued to feed them there, then their virtual saving would become effective saving. The unproductive consumption of the surplus farm population would become productive consumption." 51/ Under such conditions, the only way of effectively mobilising domestic savings is by squeezing out surplus labour and providing it jobs in local industries and Government and public undertakings. On the one hand it will release a large

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51/ Problems of Capital Formation in Underdeveloped Countries : R.Nurkse; P.37

amount of rural savings for productive purposes, which were hitherto utilised for consumption purposes, and on the other hand the unemployed labour would yield and add more to the gross national product.

In view of the scare resources a number of underdeveloped countries are utilising investment controls. But such controls should be imposed to check the flow of capital into wrong directions. They should be meant to ensure a larger proportion of imports to take the form of necessary capital goods and raw materials and side by side a larger proportion of internal resources will be saved. But to achieve this a 'single key' control device is not adequate. These countries should use drastic import and exchange controls in combination with high taxation on real estate, a selective credit policy designed to encourage industry and agriculture and discourage non-essential consumption, and a system of tax exemptions for new and necessary industries.

CHAPTER III

INSTITUTIONAL FACILITIES FOR FINANCING ECONOMIC GROWTH

The inadequacy of capital and technical know-how has impeded the economic growth of most of the underdeveloped countries. The shortage of capital for industrial and agricultural investment is an important drawback of underdeveloped countries. The less developed countries, spurred by the rapidity of their political advancement during recent years consider it essential to achieve their economic growth at a faster pace, but their resources do not permit the accumulation of earnings sufficient to finance a rate of economic growth which may be considered satisfactory for raising the living standards of their masses. Some capital usually does exist in the form of private savings, but it is much too inadequate in relation to the needs of their developing economies. Most of these countries lack an effective mechanism for diverting a large proportion of their meagre savings into productive investment. Many of them also suffer from inadequacy of initiative on the part of the industrial community - a disinclination to seek and to venture into new areas of activity.

A nation's economy, to be sound and stable, requires the existence of a sound banking system. The organisation, operation, and maintenance of banking institutions, capable of providing adequate facilities and rendering efficient service to those in need of their assistance, constitute the very life blood of a country's economy. For the healthy growth of private enterprise and progressive agriculture, a well-balanced industrialisation, an efficient transport system and for effective methods of distribution, the existence of banks, responsive to the needs of the economy is indispensable. The different types of capital, credit, and other financial services and facilities

needed by the agricultural, industrial and commercial sectors, however, have rendered imperative the division of banking activities and functions into specialised types of banking institutions, each one aiming at distinct objectives and at adopting policies and methods peculiar to its particular field or area of operations. Thus we have commercial banks, investment and mortgage banks, development banks, trust companies, rural banks and savings banks, etc. However, the success of these institutions depends on the environment and conditions in which they function.

One of the serious impediments in the way of the establishment of more private industrial plants in the underdeveloped countries is the lack of facilities for long-term finance. Certain underdeveloped countries have fairly well-developed facilities for meeting short-term credit requirements of trade, but most of them lack institutions for providing medium and long-term finance for industrial and agricultural development. The absence of organised facilities for industrial finance is partly due to shortage of capital, but even more to a failure to develop an industrial type of capital market. The inability of the underdeveloped economies to provide long-term loans is a serious limitation both on the size and number of industrial projects which can be undertaken in many countries. The availability of facilities of finance both for agriculture and industry would accelerate the rate of economic growth to an optimum level consistent with the needs of their rapidly growing population. Industrial loans provide a means for Government to ~~xx~~ encourage projects of high economic priority without the rigidity inherent in a system of controls. They also enable the Government to play a vital part in the promotion of new projects while obtaining the advantages of private management. To help overcoming these obstacles and in supplying the missing ingredients, development banks have been devised.

These specialised institutions are in a better position to investigate and supervise industrial loans than a Government department, which has other responsibilities. "The success of these institutions in stimulating new investment in and by the private industrial sector and in making available new skills and enterprise as well as capital, has proved their value as instruments of economic development in their own right."[1/] These banks have come into existence in response to the particular needs of the country which they serve and to the political, economic and social environment in which they function. They differ in respect of organisation and scope of activity. In some countries, they are state institutions, in others their capital is owned by Government and private interests in combination, while in still others, they are entirely owned and controlled by private enterprise.

The establishment of the development corporations is an indication of the widespread recognition that economic progress in the underdeveloped countries requires a concerted public action on an increasing scale. Development corporations are the tool, which the underdeveloped countries are utilising with varying degrees of success to accelerate their economic growth. Most of them assist industrial enterprises exclusively, some have to finance large-scale commercial agriculture, or agricultural undertakings integrated with manufacturing operations. Within the industrial sector, normally, only manufacturing or processing enterprises are eligible for assistance.

Agricultural finance

In agrarian underdeveloped economies, credit is the first demand of farmers. The cultivators ~~x~~ need short-term credit to purchase seed, fertilisers and other supplies and also to cover wages at the

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1/ Problems and Practices of Development Banks, Shirley Boskey; P.5, I.B.R.D., 1959.

time of sowing and harvesting of crops. Medium-term credit is required to purchase cattle, modern equipment and to make other improvements on the farm. Finally, long term credit upto 20 to 30 years is required for bringing about permanent improvements, for construction of buildings, the enlargement of existing holdings or the acquisition of new farm lands.

In underdeveloped countries unorganised money markets play a very important role in providing finance in the rural areas. These markets are much less homogenous than the organised markets and are generally scattered over the rural sector. There is very little contact between the lenders and the borrowers in different localities as a result of which they remain unaware of the rates at which the loans are transacted in other parts of the country. In the unorganised money markets, the borrowers are small agriculturists, cottage industry workers, and a few retail shop keepers. In these markets, the suppliers of credit consist of a few financial institutions such as cooperatives, private and Government sponsored agricultural banks, indigenous bankers, professional money lenders, large traders, land lords and shop-keepers, relatives and friends.2/ The interest rates in the unorganised money markets are generally high in relation both to those in the organised money markets and to those needed for rapid economic growth. " These high interest rates are caused by a disproportionately large demand for loanable funds coupled with a generally inelastic and limited supply of funds.

2/ In Burma the unorganised money market was made up of petty money lenders and gold merchants who changed exorbitant rates of interest (see p.2, of Central Banking in South and East Asia : S.G.Davies : 1960), in Ceylon, money lenders rates varied from 10.6 per cent to 36.4 per cent in 1951 and in Thailand, the interest rates in the unorganised money markets varied from 3.61 per cent to 21.13 per cent (see I.M.F.Staff Papers; P.99, Vol. VI, No.1, 1957)

The large demand stems from the special social and economic factors prevalent in the rural areas of underdeveloped countries. The low level of income leaves little surplus for saving and for the accumulation of capital for self-financing of agricultural and handicrafts production.[3/]"

Due to the exorbitant rates of interest the deadweight agricultural indebtedness is widespread amongst the south East Asian countries.[4/] As a result of this, the cultivators are left with no alternative other than to sell their crop to traders at low prices which do not have enough margin for the cultivators. Besides, this quickens the pace of alienation of land from agriculturists to money lenders and increases agrarian unrest and finally, it leads to slowing down of economic progress.

Table No.20

Sources of Agricultural Credit[5/]

(Per cent of Total)

Source of Credit Supply	Ceylon 1950-51	India 1951-52	Japan 1950	Pakistan 1951	Thailand 52-53	U.S. 1952
Institutional Sources	46	7	49	16	16	58
Commercial Banks	8	1	3	-	-	30
Cooperatives	7)	3)				
Government & Government Owned Institutions	31)	3)	45	3	1	4
Others	-	-	1	-	-	19
Non Institutional Sources	54	93	51	84	84	42
Professional Money Lenders	50	70	-	1	20	-
Traders and Shop-keepers		6	-	3	17	-
Land lords	4	2	-	17	1	-
Relatives, friends & others		16	-	63	46	-

3/ 'Interest rates outside the Organised Money Markets of Underdeveloped Countries : U.Tun Wai : I.M.F. Staff Papers : P.80, Vol.VI, No.1, November 1957.

4/ Ibid : P.126

5/ Ibid : P.87

In a majority of the Asian countries leaving aside Ceylon and Japan, most of the credit to the agricultural sector is provided by the non-institutional sectors. In India, in 1951-52, only about 7 per cent of the agricultural credit came from the institutional sector, while the non-institutional sources provided about 93 per cent of the agricultural credit. In Pakistan and Thailand also, only 16 per cent credit was provided by the institutional sector, while 84 per cent of the credit needs were met by the non-institutional sources. Contrary to this, in Japan and U.S. 49 per cent and 58 per cent of the credit needs of the agricultural sector were fulfilled by the institutional sources in the year 1950 and 1952 respectively. The rest of the credit needs of the agricultural sector were met by the non-institutional sources.

Thus the fact that unorganised money markets cater mainly to the financial needs of the agricultural sector, which is of greater importance in an underdeveloped country than in a developed country, justifies the conclusion that the relative importance of the unorganised money market is probably much greater in the underdeveloped countries than in the developed countries.

The main disadvantages of non-institutional credit are high rates of interest to the borrower, exploitation of borrowers in the interest of the lender in various ways, costly credit, production at high costs and at an inadequate level and stagnant economic growth. It is, therefore, necessary that non-institutional credit should be replaced by institutional credit.

Supply of Institutional Credit

Commercial banks provide negligible finance to the rural sector firstly, because the banking system in underdeveloped countries is rudimentary and mostly the commercial banks are

concentrated in urban areas. "Out of the 20 commercial banks existing in 1948 in Burma, 18 were foreign banks, with head offices abroad, whose main business was to provide short term foreign trade finance and seasonal finance of rice production.6/" In Viet-Nam, " there are only ten private commercial banks in the country, and of these, eight are foreign banks whose activities are confined to foreign trade finance.7/" Secondly, the borrowers fail to satisfy -- minimum standards of creditworthiness laid down by the commercial banks. Below is given the extent of the commercial bank credit to the agricultural sector in a few Asian countries.8/

Table No.21

Commercial Bank Credit to the Agricultural Sector in a few Asian Countries.

Country / Year	Commercial Bank Credit to Agriculture as percentage of their total credit to private sector						
	Burma	Ceylon	Indo-nesia	Pakis-tan	Phili-ppines	Thailand	India(*)
1948	3.9	5.0	-	-	-	-	-
1949	-	-	-	-	-	0.7	-
1950	-	-	-	-	34.4	-	2.3
1951	-	-	-	-	-	-	2.1
1952	1.5	-	-	-	40.5	-	-
1953	1.9	-	14.5	2.9	-	-	-
1954	0.3	-	13.9	1.9	38.2	0.7	0.8
1955	-	-	-	-	36.3	-	1.3
October 1959	-	-	-	-	-	-	2.7
October 1960	-	-	-	-	-	-	0.6
April 1961	-	-	-	-	-	-	0.6
Sept. 1961)@	-	1.9	-	-	-	-	-
June 1962)	-	2.0	-	-	-	-	-

6/ Central Banking in South and East Asia : S.G.Davies, P.2,(1960)

7/ Ibid,P.186

8/ Interest Rates outside the Organised Money Markets of Underdeveloped Countries : U.Tun Wai; I.M.F., Staff Papers Vol.VI, No.1, November 1957, P.129

* Trend and Progress of Banking in India : 1951, statement 30, 1955, statement 18, 1960, statement 24,1961,statement 14

@ Calculated from Table No.11, F-5, P.78, Central Bank of Ceylon, Annual Report for the year 1962.

Cooperative Banks

During the recent past the cooperative movement has almost been firmly established and is gaining strength in Asia. It began as early as 1904 in India and Burma, in 1912 in Ceylon, and in 1916 in Thailand. In Indonesia and Philippines, it was established much later and is generally less important there than in other Asian countries. In Indonesia, cooperative societies are not important because of the larger role played by the Government operated pawnshops and the village banks. In Philippines, defects in the system ~~x~~ in land tenure were grave obstacles to the development of agricultural credit in general and to the establishment of cooperative movement in particular.9/

Ceylon and India possess a well-developed and vigorous cooperative movement. It furnishes leadership and guidance in the solution of many agrarian problems, such as effective utilisation of the existing resources and in the introduction of improved methods of cultivation. It performs an important educative role, both in the training of local leaders and in quickening the awareness of the peasant to the opportunities that are open to him. Cooperatives also provide a large share of agricultural credit on reasonable terms.10/

In Burma, cooperative societies advance loans for short periods at 12 per cent rate of interest. In Cambodia, they provide short-term loans upto 18 months and cover one-third value of the harvest, medium-term loans upto eight years and cover one-third of value of the real estate and long-term loans for a period of 15 years. The rates of interest charged on short-term loans are 12 per cent, on medium-term loans 8 per cent and 4 per cent on long-term loans.

9/ Interest Rates outside the Organised Money Markets of Underdeveloped Countries; U.Tun.Wai, I.M.F. Staff Papers : Vol. VI, No.1, 1957, P.90

10/ The Economic Development of Ceylon : I.B.R.D., Washington D.C.1952, P.58. Also see Pp.13,14, Annual Report,1963, Central Bank of Ceylon.

In India and Ceylon, cooperatives usually provide only short-term loans. Their rate of borrowing varies between 3 per cent and 6 per cent. In India, the lending rate of the societies varies between 6 per cent and 12 per cent, while in Ceylon it varies between 9 per cent and 12 per cent. In Indonesia, the borrowing rate varies between 6 per cent and 12 per cent, while the lending rate is 20 per cent. But the net lending rate is only 12 per cent, because 8 per cent is forced saving. In Philippines, cooperatives advance short and medium term loans at 8 per cent rate of interest, while 5 per cent is their borrowing rate. In Thailand, cooperative societies give short and medium term loans at 9 to 10 per cent rate of interest, while long-term loans upto 15 years are given at 6 per cent. Their borrowing rate varies between 4 to 6 per cent. Cooperatives in Viet-Nam give crop loans from 12 to 18 months, medium-term loans from 2 to 8 years, and long-term loans upto 15 years at 10 per cent, 8 per cent and 6 per cent rate of interest ~~rsp~~ respectively.11/ Thus the above analysis is an indication of the fact that there is much difference between the borrowing rate and the lending rate of the societies.

Table No.22

Indian State Cooperative Banks Credit between 1951-52 to January 1964.12/

Year	1951-52	1955-56	1957-58	1959-60	1960-61	1961-62	1962-63	31st Jan. 1964
Amount of Credit in Lakhs of Rupees	17,58	25,35	51,19	97,17	62,08	160,97	182,90	199,46

11/ Interest Rates outside the Organised Money Markets of Underdeveloped Countries : U.Tunwai; I.M.F. Staff Papers, Vol.VI, No.1, November 1957, PP.134, 135.

12/ Reserve Bank of India Bulletin; P.199 , February 1964.

Table No.23

Loans Granted by the Agricultural Credit and Cooperative Financing Administration in Philippines, 1953 to 1958 13/

(Thousand of Pesos)

Period	Total amount	Crop Loans	Farm Improvement Loans	Commodity Loans	Facility Loans	Other Loans
1953	2,789	2,173	467	41	108	-
1954	15,720	8,920	4,266	1,342	1,192	-
1955	40,528	16,532	7,020	7,669	6,817	2,490
1956	44,491	13,459	6,063	11,725	9,996	3,248
1957	48,847	7,458	2,634	6,004	5,489	27,262
1958	23,905	4,267	8,327	9,994	849	8,467

In Ceylon, inspite of the rapid growth within the past decade the island is still not covered adequately especially by credit cooperatives and by marketing and production societies. 14/ In Ceylon, "where the cooperative movement supplied 7 per cent of total rural credit in 1951.....after 43 years of activity, the ~~Ceylon~~ movement can be said to have touched the bare fringe of the whole problem......Our credit societies are making much headway over short term loans, but adequate facilities for medium and long term loans are a crying need." 15/ In other countries, such as Thailand, dissatisfaction has often been expressed that the cooperative movement, though useful as a means of channelling Government funds to the agricultural sector has not been of importance in the mobilisation of domestic capital. 16/

In Asia, Governments have been a source of finance for the cooperative movement, In the early days of cooperation in Ceylon, cooperative credit societies were helped financially by loans from the local loans and Development Fund financed by the Government. In

13/ Central Bank of Philippines Statistical Bulletin : P.49, Table No.26, Vol. X,No.4, December,1958

14/ The Economic Development of Ceylon; I.B.R.D.(1952) Pp.58,59.

15/ Interest Rates outside the Organised Money Markets of Underdeveloped Countries : U.Tunwai, I.M.F. Staff Papers, Vol. VI,No.1, November 1957, P.89

16/ Ibid : P.90

India, in 1947-48, Government loans made up 1.61 per cent of the total working capital of the cooperative movement. The Rural Industrial and Development Authority in Malaya is one example of a Government sponsored financing institution lending to cooperative societies, another is the Agricultural Credit and Industrial Cooperation of Ceylon.[17] Generally, the Governments have channelled most of their loans to agriculturists through cooperative societies or similar associations. Burma is an exception to this. Here, " direct loans from the Government have been much more important than loans granted through cooperative societies.[18]"

Measures to Increase the Supply of Institutional Credit

During the last decade, to establish a closer link between the unorganised and organised money markets, the Governments in the underdeveloped countries have set up special institutions. They include State Agricultural Bank of Burma, Office of Public Credit of Cambodia, The State Mortgage Bank and Agricultural and Industrial Credit Corporation of Ceylon. In Philippines, the Agricultural and the Rehabilitation Finance Corporation are the specialised agencies which extend credit to the rural sector. In India and Thailand, Government is the main source of providing institutional finance, while in Pakistan, besides Government, Agricultural Development Finance Corporation is another institution, which provide finance to the organised rural sector.

With a view to improve the lending machinery of Government and Central Bank agencies as well as to increase the supply of institutional credit to agriculture, the Reserve Bank of India Act was amended in 1955 to enable the Reserve Bank to establish (a) The

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17/ U.N.Cooperative Thrift Credit and Marketing in Economically Underdeveloped Countries; F.A.O.,(1959),P.61

18/ Interest Rates Outside the Organised Money Markets of Underdeveloped Countries; U.Tu Wai, Vol.No.1, November 1957, P.93

National Agricultural Credit (Long Term Operations) Fund and supply it with funds consisting of an initial sum of Rs.100 million plus a minimum of Rs.10 million per year in the first five years, and (b) The National Agricultural Credit (Stabilisation) Fund with a minimum contribution by the Reserve Bank of Rs.10 million per year for the first five years.

Table No.24

Advances of the Reserve Bank of India to State Cooperative Banks [19]

(In Lakhs of Rupees)

Year	Total		Section (2)(b)		Section 17(4a)		Section 17(4c)		Section 17(4A)3	
	Advances	Outstanding	Advances	Outstanding	Outstanding	Advances	Advances	Outstanding	Advances	Outstanding
1951-52	1129	781	199	196	226	489	441	360	-	-
1955-56	2380	1298	44	39	214	1036	1259	994	41	51
1960-61	14666	8940	-	-	393	2979	11541	7784	429	763
1961-62	19292	12280			490	3233	15339	10699	721	1092
1962-63	22028	13432			671	5039	16631	11826	358	935
Jan.1964	1580	14054			684	134	1446	12512	-	858

In Ceylon, till the setting up of the Agricultural and Industrial Credit Corporation of Ceylon in 1943, there were no organisations or credit institutions for supplying institutional credit. Hence the corporation was set up for providing financial assistance for the development of new enterprises and for the refinancing of agricultural debt. "The Corporation may grant loans only on a primary mortgage of property the title to which should be acceptable to the Board of directors of the Corporations."[20]

Loans granted by the Agricultural and Industrial Credit Corporation rose from Rs.4.5 million in 1958-59 to Rs.5.1 million in 1959-60. Loans for agricultural purposes rose by Rs.1.1 million to

19/ Reserve Bank of India Bulletin, P.203, Table No.12, February,1964.

20/ U.N.,Mobilisation of Domestic Capital : P.124, Sales No.1953-II,4

Rs.4.5 million. Of the total loans given by the Corporation in 1947-48, 90 per cent went to the agricultural sector, while 10 per cent went to the Industries. In the year 1950-51, loans given to the agricultural sector accounted for about 92 per cent, while loans given to the industrial sector accounted for 8 per cent. In 1951-52, agricultural credit was 86.7 per cent of the total loans of the corporation.

Table No.25

Agricultural & Industrial Credit Corporation of Ceylon Loans granted in Millions of Rupees.[21]

Year	LOANS FOR AGRICULTURE PURPOSES		FOR INDUSTRIAL PURPOSES		total loans
	Amount	Percentage of the total loan	Amount	Percentage of the total loan	
1945-46	3.15	91.0	0.19	9.3	3.34
1949-50	6.06	92.3	0.49	7.7	6.55
1951-52	8.29	80.8	1.95	19.2	10.25
1953-54	5.21	94.4	0.30	5.9	5.51
1956-57	3.61	90.0	0.40	10.0	4.01
1957-58	3.21	89.4	0.37	10.6	3.59
1958-59	3.34	75.7	1.10	24.3	4.53
1959-60	4.47	87.5	0.63	12.5	5.11
1960-61	2.64	82.5	0.56	17.5	3.20
1961-62	2.02	86.7	0.31	13.3	2.34
1962-63	2.81	81.6	0.63	18.4	3.44

In Ceylon the security that is easily available is land. But agricultural land is not the most desirable security for long term loans. Therefore, " Long term lending is somewhat hazardous, where the risks of lending cannot be calculated even approximately, the tendency on the part of a lender would be to adopt a cautious policy."[22]

The Agricultural Development Finance Corporation of Pakistan was set up in 1952 to provide financial assistance on a long term basis and at reasonable rates of interest to individuals and concerns who are in a position to formulate and work schemes for affecting improvement in agriculture. The important feature of the corporation

21/ Central Bank of Ceylon, Annual Report 1963, Table No.15.
22/ U.N.Mobilisation of Domestic Capital P.195, Sales No.1953,II.4

is, that it was designed to grant most of the loans in kind and only to a restricted extent in cash. This is hoped to eliminate the chances of the loans being spent by the borrowers in wasteful and unproductive fields.

According to the Charter of the Corporation, it does not provide loans exceeding Rs.0.1 million in the case of corporate bodies, including both in cash and kind.[23] But to remove this rigidity and to maintain some elasticity in regard to the amount given to the borrowers, the Government has been empowered to use its discretion to relax this limit upto Rs.0.5 million in the case of individuals and Rs.2.5 million in the case of corporate bodies. In order that the corporation may assist even the smallest of the agriculturists, it has been authorised to grant loans not exceeding Rs.500 to individuals only on the security of a bond with one surity.

The authorised capital of the corporation is Rs.50 million of which not less than 51 per cent is to be contributed by the central Government. The Corporation has also been authorised to borrow loans in foreign currency from the International Bank or from other sources. Further, to give more financial help to the agricultural sector, the Pakistan Government has created a number of special funds largely out of its budget surpluses. The Agricultural Development Fund received Rs.50 million in 1952-53 from the budget surplus.[24]

23/ U.N.Mobilisation of Domestic Capital, P.229, Sales No.1953, II.4

24/ Ibid : P.27

Table No.26

Agricultural Loans Granted by Selected Financial Institutions 25/
in Philippines, 1947 to 1958

(Thousand Pesos)

Period	Total amount	Loans to Agriculture	Agricultural Loans as Percentage of total amount of loans
1948	95,662	9,999	10.4
1949	1,03,522	16,328	15.7
1950	68,434	15,143	22.1
1951	97,424	13,525	13.9
1952	1,71,769	24,458	14.2
1953	1,40,298	28,550	20.3
1954	1,47,525	34,429	33.3
1955	1,90,522	65,213	34.2
1956	3,05,216	69,949	22.3
1957	3,83,886	74,665	19.4
1958	3,15,876	69,327	21.9

Table No.27

Loans Granted by the Special Financial Institutions 26/
to Agriculture in Philippines .... (1948-58)

(Thousand Pesos)

Year	Loans given by Development Bank of Philippines (a)			Agricultural Credit and Cooperative Financing Administration Total Loans granted
	Total Loans granted	Agricultural Loans	Percentage of agricultural loans to total loans	
1948	90,885	9,999	11.0	
1949	95,845	16,328	17.3	
1950	53.837	15,143	28.1	
1951	76,967	13,525	17.5	
1952	1,43,976	24,458	16.9	
1953	1,12,958	25,761	22.8	2,789
1954	78,127	18,709	23.9	15,720
1955	73,592	24,685	33.5	40,528
1956	1,01,201	25,246	24.0	44,451
1957	93,037	25,761	27.6	48,847
1958	49,930	25,125	50.0	23,905

The Development Bank of Philippines provides credit both for agriculture, industry and real estate. In 1950, 28.1 per cent loans were given to the agricultural sector. In 1952, the agricultural

25/ Central Bank of Philippines Statistical Bulletin, P.41, Table 18, Vol.X.No.4, December 1958.
26/ Ibid : PP.43 and 49
27/(a) Formerly known as Rehabilitation Finance Corporation.

loans accounted for Rs.16.9 per cent. In 1958, agricultural loans extended by the corporation accounted for about 50 per cent.

Another specialised agency, the Agricultural Credit and Cooperative Financing Administration gave loans to the extent of Pesos 2,789 thousand. This sum in 1957 rose to Pesos 48,847 thousand but, in 1958, it came down to Pesos 23,905 thousand.

The subsidiary project scheme of the Agricultural and Rural Development Five Year Plan of Burma included the establishment of an Agricultural Bank for the provision of credit on reasonable terms to the cultivators.27/ A state agricultural bank has been established in Burma which has extended large sums in the form of loans and subsidies to cultivators for the extension of rice, ground nut and jute acreage. The ~~Bak~~ Bank is permitted to ~~b~~ grant mostly seasonal loans and only to a limited extent the medium term credits to agriculture at 6¼ per cent rate of interest. The office of public credit in Cambodia provides loans for the purchase of land for a period of four years only at four or five per cent rate of interest.28/

In Ceylon, the State Mortgage Bank provides medium and long term loans to the agriculturists.

Table No.28

Loans Granted Outstanding and Repaid by Ceylon State Mortgage Bank 29/
(Rupees in Thousand)

Period	Loans granted	Capital repayments	Total loans outstanding at the end of the period
1948-49	2,400	639	8,133
1955-56	5,586	2,060	26,128
1956-57	12,605	2,833	35,900
1957-58	9,403	2,536	42,767
1958-59	8,628	3,016	48,380
1959-60	11,797	4,040	56,135
1960-61	4,284	4,147	56,272
1961-62	2,937	3,851	55,359
1962-63	2,930	3,742	55,050

27/ Planning a Welfare State in Burma, John Lloyed : International Labour Review, P.134, Vol.LXX, No.2, August, 1954.

28/ Interest Rates Outside the Organised Money Markets of Underdeveloped Countries : U.Tun Wai; P.134, I.M.F., Staff Papers, Vol. VI.No.1, November 1957.

29/ Central Bank of Ceylon, Annual Report 1963, Table 14

The supply of agricultural credit in the underdeveloped countries should be increased in such a way that the legitimate needs of the agriculturists are met at a cheaper rate without encouraging borrowing for consumption. This can be achieved by increasing institutional credit, while at the same time taking steps to discourage borrowing from non-institutional sources.

Any programme to bring down interest rates in unorganised money markets must be comprehensive and should be guided by the principle that interest rates can be lowered by reducing the demand for loanable funds and/or by increasing the supply thereof. The demand for loanable funds for financing consumer expenditure can be reduced by changing social habits and concepts of acceptable standards of well being.

The way to induce the organised financial institutions to lend more to agriculture is by making agriculturists more creditworthy and generally reducing the risks of lending by lessening the impact of some of the natural calamities, reducing carelessness, and increasing honesty, reducing the uncertainties of the market through crop insurance, stabilized agricultural prices etc. Another way of encouraging institutional lending is by Government guarantees of agricultural loans.

The institutions established in this field need to be exceptionally well organised and intelligently controlled. Security of loans is one of the basic problems. Short term credit which is given to the peasant can be offered on the security of annual crop. At the same time, long term credit and medium term credit need to be secured against some thing more tangible. What is important is that some central agency should control, coordinate and supervise the operations of the individual institutional agencies for credit.

Industrial Finance

Commercial Banks in the region have been chiefly concerned with trade financing and have paid relatively little attention to financing of industries. Even when they supply credit to industries, it is mostly short term credit to finance current transactions.

In India, the commercial banks follow the traditional British practice inasmuch as they supply short term financial needs of industries for working capital. They advance funds on the security of floating assets secured by the personal guarantee of the managing agents. Before independence there were no institutions in India of any organised character " which would do for Indian Industry what the issue houses and trusts and financial companies do for England or what the German banks do for Germany."[30/] Indian industry has lacked the assistance of an institution, which would help in the formation of the industrial company and in placing its shares and securities on the market. Till now this service has been done by the managing agents in our country, who obtained the additional capital from parties associated with them and who invested their own money. Even bank finance was provided on the personal guarantee of the managing agents.

Banks in India provide mostly working capital requirements of industries. The following table shows the analysis of bank advances in India :-

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30/ Industrial Organisation in India, Dr. Lokanathan; P.236

Table No.29

Bank Advances in India 31/

(Crores of Rupees)

Period	Industry	Commerce	Agricultural	Professional & Personal	Others	Total
30th June 1951						
Scheduled Banks	208.6	294.5	15.9	39.6	25.6	584.3
Non-Scheduled Banks	7.3	19.7	2.5	11.3	2.6	43.3
Total	215.9	314.2	18.4	50.9	28.2	627.6
Percentage to total advances	50.0	35.8	0.8	9.5	3.6	100.0
30th June 1955						
Scheduled Banks	241.2	292.3	12.5	54.8	24.9	625.6
Non-Scheduled banks	6.2	18.3	2.3	9.9	2.3	39.6
Total	247.4	310.6	14.8	64.7	27.2	665.2
Percentage to total advances	37.1	46.8	2.1	9.6	4.4	100.0
October 28,1960						
Scheduled Banks	562.8	395.2	6.6	96.8	38.6	1100.0
Non-Scheduled Banks	3.9	10.1	2.1	11.8	2.4	30.3
Total	566.7	405.3	8.7	108.6	41.0	1130.3
Percentage to total advances	50.0	35.8	0.8	9.5	3.6	100.0
October 27,1961						
Scheduled Banks	666.0	413.5	8.4	106.2	33.5	1227.7
Non-Scheduled Banks	2.97	7.27	1.6	9.1	1.8	22.7
Total	668.97	420.77	10.0	115.3	35.3	1250.4
Percentage to total advances	53.5	33.6	0.79	9.2	2.82	100.0

On 30th June 1951, out of the total advances of scheduled banks and non-scheduled banks amounting to Rs.627-37 crores, Rs.215.38 crores or 34.3 per cent were advanced to industry, while Rs.311.7 crores or 49.7 per cent were given to commerce and trade. On 30th June,1955, industry accounted for Rs.247.19 crores or 37.1 per cent of the total advances, while commerce accounted for Rs.311.9 or 46.8 per cent. On October 27, 1961, the total advances given to industry by the commercial banks accounted for Rs.669.0 or about 53.5 per cent of the total advances

31/ Prepared from statements 30 and 32, Trend and Progress of Banking in India during 1951; statement 24 and 26 of 1955, 1960 statement 18, and 1961 statement 14.

while at the same time commerce secured Rs.421 crores or 33.6 per cent of the total advances. The increasing trend in the advances offered to the industries by the scheduled banks in India is an indication of their growing confidence in industrial investment and production.

Some banks make advances to industries against fixed assets also, but their aggregate amount may be small. It should, however, be pointed out that a part of the advances of commercial banks for working capital is also in use for a long period of time. Though this part of the finance revolves or rolls over, in actual effect it does serve the needs of providing finance for long periods to a certain extent.[32/]

Apart from the use of working capital for long period needs, banks in India indirectly participate in long term industrial finance.

Table No.30

Indirect Participation by Commercial Banks in Long-Term Industrial Finance[33/]

(Crores of Rupees)

Year	Investment in shares and deventures of industrial concerns	Advances against shares and debentures	Total
(A)June 30,1951	13.80	53.24	67.04
(B)June 30,1955	15.06	52.74	67.80
(C)December 31,1959	24.33	98.46(a)	122.79

Thus the indirect participation of commercial banks in India in long-term industrial finance is slightly on the increase, but it is a very small proportion of the total advances made by them. This is due to the nature of their liabilities which are payable on demand or after a short period of time and it is also due to the fact that there are risks inherent in long term advances to or investments in industry.

32/ Commercial Banks & Industrial Finance: Dr.K.K.Sharma,Agra University Extension Lectures, Agra,University Press,(1956)P.21

33/ Prepared from Trend & Progress of Banking in India. (A) Statements 21,31 and 33 for the year 1951 (B) Statements, 22,25,and 27 for the year 1955, (C) Statements 19,and 15 for the year 1960.

(a) Figures are for December,1960.

Table No. [illegible]

[illegible] 24/

([illegible])

Date and Year	Advances of scheduled bank to industries	Percentage to total advances	Deposits of scheduled bank	Percentage of advances to deposits
31.12.1951	[illegible]	[illegible]	[illegible]	[illegible]
31.12.1952	170.[illegible]	[illegible]	[illegible]	21.7
31.12.1953	[illegible].5	[illegible]	[illegible]	[illegible]
31.12.1954	[illegible]	[illegible]	[illegible]	[illegible]
31.12.1955	211.0	[illegible]	1,[illegible].4	[illegible]
25.10.1957	[illegible].7	[illegible]	[illegible]	[illegible]
[illegible].10.1960	[illegible]	[illegible]	1,[illegible]	[illegible].7
27.10.1961	[illegible]	[illegible]	1,[illegible].4	[illegible].4

In 1960, the amount of advances showed an increase as compared to the previous years, and total deposits are also gradually rising, but the percentage of advances to total deposits remains almost unchanged except on 31st December, 19[illegible], when the percentage drops to [illegible].7.

On 31st December 1951, the deposits of scheduled banks stood at Rs. [illegible] crores and on 31st December, 19[illegible], they stood at Rs. 1,[illegible] crores. On October [illegible], 1961, the deposits of scheduled banks accounted for Rs. 1,[illegible].4. During the four years of the First Plan period, there was an increase of Rs. 184 crores in the deposits of scheduled banks which meant a rise of about [illegible] per cent. Between December 19[illegible] and October 19[illegible], there was an increase of about Rs. [illegible] crores or about [illegible] per cent. Thus bank deposits in the Second Plan period increased at a faster rate than in the First Plan period.

Since 1952, the banking sector in [illegible] has expanded gradually. Four new commercial banks, with a total of [illegible] branches throughout the country have been established. They are the

24/ Prepared on the basis of statements relating to analysis of advances and deposits of Banks, Trend and Progress of Banking in India during the year 1953, 1954, 1955, 1957, 1960 and 1961.

Burmese Economic Bank, the Union Burma Cooperative Bank and the most important of these new banks is the State Commercial Bank. The letter's paid-up capital has entirely been subscribed by the Government. Within four years the State Commercial Bank ~~x~~ had opened eleven branches and expanded deposits from Kyat 11 million to Kyat 360 million. The State Commercial Bank has filled an important gap in the country's financial system by making working capital available to local industries.[35/] The total number of bank offices in Pakistan rose from 195 in July 1948 to 369 in June 1959. This has been due mainly to the expansion of Pakistani banks. There has also been an impressive growth in bank deposits, which stood at Rs.2,762.7 million in June 1959 as compared to Rs.880.5 million in July 1948.[36/] The commercial banks cannot provide enough medium term and long term agricultural or industrial finance on account of the predominance of demand deposits in the structure of their deposit liabilities.[37/]

Table No.32

Trend of Commercial Bank Deposits in Ceylon (1946-1960)[38/]

(Rupees in Millions)

Period	Demand Deposits Amount	Demand Deposits Percentage of the total deposits	Time and Savings Deposits Amount	Time and Savings Deposits Percentage of the total deposits	Total
1949	740.5	91.7	66.7	8.3	807.2
1952	621.9	85.7	103.4	14.3	725.3
1955	745.4	82.9	165.4	17.1	910.8
1960	684.9	65.0	372.2	35.0	1,057.1
1961	657.3	64.0	363.8	36.0	1,021.0
1962	756.1	63.1	426.4	36.9	1,182.5
1963	802.1	61.6	499.2	38.4	1,301.3

Demand deposits in Ceylon in 1949 accounted for Rs.740.5 million or 91.7 per cent of the total deposits while the time and

35/ Central Banking in South and East Asia by S.G.Davies : P.3(1960)
36/ Ibid : PP.146 and 148
37/ Ibid : P.149
38/ ~~Ibid~~ Central Bank of Ceylon Annual Report 1963, Table 4

savings deposits accounted for Rs.66.7 million or 8.3 per cent. In 1963, demand deposits stood at 802.1 million or 61.6 per cent of the total deposits, while at the same time, time and savings deposits rose to Rs.499.2 million or 38.4 per cent of the total commercial bank deposits.

Thus so long as the percentage of time deposits to total deposits of the commercial banks does not increase, the banks cannot provide sufficient loan capital to meet the long term and medium term needs of the industries. For increasing the time deposits of the commercial banks, it is necessary that the Government should ensure the safety of deposits in commercial banks. Government should guarantee the repayment of medium and long term loans extended by banks, and deposits insurance scheme should be enforced.[39] The Central Bank should provide special rediscount facilities to commercial banks in respect of their medium and long term assets.

Insurance Companies :

Insurance business in most of the South East Asian countries is ill developed, and even in countries like India, where it occupies a comparatively important place and constitutes an important part of the organised sector of the capital market, it makes available only small and medium sized savings for investment. Besides, to ensure the interest of the policy holders the insurance companies spread their investment in such a way as to get the highest practicable rate of interest.

The following table shows the investment of the Insurance Companies in Philippines.

39/ Depot Insurance Corporation was established in India in ......

Table No. 33

Investments of the Insurance Companies in Philipprines (1956-1959) 40/

(Amount in Thousand Pesos)

End of period	Total investment	Loans Outstanding	Bonds and other securities: Total amount		Government issue		Private issue		Fixed deposits	Other investment
January 1956	151334	71316	38999	25.0	4238	10.9	34661	89.1	7384	33735
January 1957	187187	75998	60240	32.2	13844	22.9	46396	77.1	10258	40691
January 1958	213846	86288	68617	32.1	10381	15.1	52236	84.9	9506	49435
January 1959	243269	98842	71221	25.1	8796	12.3	62425	87.7	11951	61355

In Philippines, in January 1956, Insurance Companies granted only 0.65 per cent of their loans for industrial purposes, 11.2 per cent for commercial purposes, and 71.6 per cent for consumption. In January 1959, industrial loans accounted for 0.2 per cent, commercial loans accounted for 7.9 per cent, while consumption loans accounted for 64.7 per cent. 41/

Investment Policy of the Life Insurance Corporation in India

The investment policy of L.I.C. of India was enunciated as follows in 1958.

(a) The primary obligation of L.I.C. is to its policy holders, whose money it holds in trust, and will work as for as possible on business principles.

(b) It will abstain from speculative investment as its investment must be necessarily on a long term basis, and thus it will take advantage of temporary fluctions of market prices.

The controlled funds of the L.I.C. are divided into three broad categories. First, there are Government and approved securities, Second, investments approved under section 27 A, and finally, 'other

40/ Ibid : Vol. IX,No.4, December 1957, Table No.38
Vol.X,No.4, December 1958, Table No.35.
Vol.XI,No.4,December 1959, Table No.50

41/ See Appendix 'A' Table No.VI.

investments'. Formerly, the limitations were that 25 per cent of the controlled funds were to be held in Government securities, a further sum equal to not less than 25 per cent in Government securities, and not more than 15 per cent in other investments. Thus, about 35 per cent were to be held in 'approved investments' as defined in section 27A of the Insurance Act.

Section 27A of the Insurance Act was amended on August 23, 1958. Under Section 27A (4) of the Insurance Act, a private insurer could not hold more than 10 per cent of the subscribed share capital and debentures of any one company (other than a banking company or an investment company). This has been modified so as to allow the L.I.C. to hold upto 30 per cent of the equity share capital of a company with a further provision for exceeding this limit with the prior approval of the central Government. This higher ceiling is considered necessary, because formerly each individual insurer could hold upto 10 per cent of the subscribed share capital and debentures of a company, while it is now the common pool of 240 companies that the L.I.C. has at its disposal to invest.

The second important modification relates to section 27(A7). Under the old section, the insurers were prohibited from investing in private companies. The amendment clause 27(A7) permits the L.I.C. to invest in private limited companies also with the prior approval of the central Government.

Investment of the L.I.C.

Table No. 34 42/

Investments of Indian Life Insurance Companies as Percentage of the total assets.

	1945	1946	1947	1948	1949	1950	1951	1952	1953
Indian Government Securities	63.3	61.4	57.2	55.2	51.8	49.6	47.1	41.3	46.1
Securities of Indian States	0.7	0.6	0.8	0.6	1.2	2.1	0.6	1.3	1.1

42/ The Indian Capital Market; V.R. Cirvante; P.157

	1945	1946	1947	1948	1949	1950	1951	1952	1953
British Government and Foreign Government Securities	1.0	0.9	0.8	1.5	1.6	1.7	1.7	1.9	1.8
Municipal Port Trust and Improvement Trust Securities	5.0	5.0	5.7	5.2	5.0	4.8	5.5	6.0	5.9
Shares and Debentures of Indian Companies	9.4	10.1	11.5	12.2	13.8	14.6	14.4	14.1	15.5
Loans on Policies	5.0	4.0	4.1	4.3	4.9	5.4	5.8	6.7	7.4
Loans on stock and shares of reasonal securities	0.2	0.3	0.3	0.3	0.9	0.7	0.8	0.7	0.7
Mortgage on property	1.0	1.1	1.8	2.3	2.7	3.4	4.0	4.5	4.6
Land and house property	4.0	3.7	3.7	3.5	4.0	4.2	5.0	5.1	5.6

In India the L.I.C. investment in Government securities accounted for more than half of its total investment. In 1945, it accounted for 63.3 per cent, while in 1950, it accounted for 49.6 per cent. In 1953, the L.I.C. invested about 46.1 per cent of their funds in Government securities. " At the end of July 1958, the L.I.C. had total investments of Rs.383 crores as against Rs.361 crores at the end of June 1957 and Rs.341 crores on August 31, 1956." 43/ The percentage distribution of these among different types of investments is shown below.

43/ The Reserve Bank of India Bulletin; P.1025, September 1958.

Table No. 35

Percentage Distribution of L.I.C. Investments

	End August 1956	End August 1957	End August 1958
Government and Approved Securities	73.1	72.1	71.9
Debentures Preference and ordinary shares	16.8	18.1	19.0
Other Miscellaneous investments	10.1	9.8	9.1

The funds of Insurance Companies are very suitable for long term investments because the liquidity of assets is not the main consideration as the policies usually mature after a very long period. Therefore only a small amount need be invested in highly liquid assets and a major portion of their funds can be invested for long periods in industrial securities. Besides, investments should be spread over amongst different types of securities of various concerns having different dates of maturity to maintain the liquidity of its funds.

In India, the Corporation occupies as important a position in collecting the savings of the masses as banks do in the national a economy of the country. It should, therefore, prepare a programme of development and of opening new offices throughout the country and abroad so that funds from the public may be collected. It should devise means and methods to provide insurance facilities to the industrial workers to check their spending on undesirable consumption. The corporation should help in administering the funds under the Employees Health Insurance Scheme. Other forms of social insurance in the country can be introduced with the help of the Life Insurance Corporation. Finally, its investment portfolio should be entrusted to the Reserve Bank of India as the Central Banking, Currency and Credit Authority of the country.

In a few South East Asian countries,[44] during the planning period, insurance business has been nationalised with a view to enable the Government to rationalise business to reduce costs to regulate foreign insurance firms with the purpose of preventing the outflow of capital and to make more effective utilization of country's resources and finally to assure greater safety for life funds.

The Government of the Union of Burma passed the Nationalization of Insurance Companies Act, 1951, in order to nationalise insurance companies incorporated and registered in Burma. In Ceylon, a scheme of National Insurance by the Government covering wide sections of the people has been planned. In October 1949, the China People's Insurance Company was established in China-Mainland. Since July 1951, a compulsory insurance is compulsory for the Government agencies and public enterprises : Property insurance, Railway rolling stock insurance, Marine insurance, and passenger accident insurance. In the field of social insurance, in March 1951, a regulation for workers insurance was put into force by the Government. In June 1950, the Government of Philippines adopted legislation requiring foreign insurance companies to raise their deposits from pesos 100,000 to pesos 250,000 of which 50 per cent should consist of Philippines securities. It was further required that at least 30 per cent of their legal reserves against policies written in Philippines be set aside and invested in accordance with the provisions of the Insurance Act.

Recognising the important role which Insurance Companies play in the mobilisation of domestic capital, the Government of Pakistan has authorised the establishment of the Pakistan Insurance Corporation, which would encourage the promotion and Development of Pakistan Insurance Companies.[45]

44/ Mobilisation of Domestic Resources : PP.33 and 34,
U.N.Sales No,1953-II4

45/ Ibid : P.231

Financing of the Small Scale Industries

To encourage the development of cottage and small scale industires to compensate for unfavourable factors in smaller enterprises, in India, Ceylon, Pakistan, and Thailand, cooperatives have been providing facilities for small loans to the people. In Indonesia, Combodia, Laos and Vietnam pawnshops provide such facilities.

In Cambodia, an autonomous organisation controlling popular credit - the Office of Popular Credit of Cambodia - was set up in 1950 at Phnom-Pent within the framework of the agreements signed with the French Government.46/ The funds are supplied by the deposits of the Farmers' Bank, The Handicraft Bank, and the Small-Scale Industries Bank. The loans to Handicraftsmen and to small scale industries are only made through directly by the office and amount to only 1.2 million piastres. In 1952, a credit of 3.5 million piastres was earmarked for loan operations.47/

In 1955, in India, the National Small Industries Corporation was set up by the Government for providing finance and promoting development of small-scale industries. In order to broadbase certain activities, four subsidiary corporations were set up during February-March 1957. Together with other activities, the Corporation supplies machinery to small-scale industries on a hire-purchase basis. Since the inception of the Hire-Purchase Scheme upto the end of February 1958, the Corporation accepted 1,155 applications for 3964 machines valued at Rs.3.21 crores.48/ The Corporation had secured by the end of September 1960, 2,431 orders valued at Rs.7.58 crores for small scale industrial units. Under the Higher Purchase Scheme, the corporation had accepted, as of the same date, 3,471 applications for 13,006 machines valued at Rs.13.4 crores.49/

46/ Mobilisation of Domestic Capital;P.31, Sales No. U.N., 1953 II.4.
47/ Ibid.
48/ Report on Currency and Finance for the Year 1957-58:P.48, Reserve Bank of India.
49/ Ibid: 1960-61;P.68

The corporation charges interest at $3\frac{1}{2}$ per cent to industrial cooperatives and $4\frac{1}{2}$ per cent to other units in cases where the machinery is worth less than Rs.15,000 and where the value is more than Rs.15,000 the rates of interest are 5 and 6 per cent to industrial cooperatives and other units respectively. In the year 1960-61, the corporation has introduced certain relaxation in respect of its Higher Purchase Scheme and also simplified the procedure connected with applications from small-scale units for securing machinery under the scheme. In case of applications for machinery sponsored by the state Government, only 5 per cent of the value of the requisite machinery is now required to be given as earnest money provided the balance of 15 to 25 per cent, as the case may be, is covered by the guarantee of the sponsoring Government.50/ The activities of the corporation are financed by loans and grants by the central Government. By the end of 1957-58, the corporation was sanctioned Rs.1.30 crores as loans and Rs.28 lakhs as grants. In the year 1960-61, the corporation obtained a long term credit of \$ 10 million from the U.S. Development Loan Fund to assist small-scale industries through the supply of imported machinery on hire purchase basis. This line of credit may be used for procuring machines valued upto \$ 50,000 for a single applicant from any part of the world excepting the communist countries, machines in excess of \$ 50,000 must, however, be procured from the U.S.A. only.51/

During the year 1959-60, a noteworthy development for providing finance to small-scale industries was the formulation of a scheme by the Government of India in consultation with the Reserve Bank of India, of guaranteeing loans granted to small-scale industries by specified banks and other financial institutions including State Cooperative Banks and State Financial Corporations. The object of the

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50/ Ibid : PP.68 and 69
51/ Ibid : P.69

scheme is to provide a measure of protection to lending institutions against possible losses in respect of their advances to small scale industries i.e., units having capital investment of Rs.5 lakhs or less, for working capital purposes or for acquisition of fixed assets and equipment. The scheme provides for sharing of losses between the lending institutions and the Government of India, subject to the condition that the maximum amount recoverable against the guarantee issued under the scheme in respect of any one advance will not exceed rupee one lakh.[52]

To facilitate the operation of the scheme the following changes were proposed in 1960-61 : (a) Under the earlier participation arrangement, advances granted by banks and financial institutions other than those specified under the scheme were eligible for guarantee facilities only if a specified credit institution participated in such advances to the extent of not less than 25 per cent of the amounts thereof (b) To enable the State Financial Corporations which usually grant loans for periods of 10-12 years to take full advantage of the scheme, it was proposed to make advances for periods exceeding seven years also eligible for guarantee, provided, however, that the guarantee would not extend beyond seven years from the date of first disbursal of the advance.[53]

Measures taken to supply Institutional Credit to Industries

The problem of industrial finance has assumed great importance in underdeveloped countries in the post-war years owing to the stagnation in the capital market on the one hand the desire of their Governments to accelerate the pace of rehabilitation and expansion of industries on the other.

A number of countries in the region including Burma, Ceylon, India, Indonesia, Pakistan, Philippines and Thailand have recognised

52/ Ibid : 1959-60; P.52
53/ For details see Report on Currency and Finance for 1960-61,P.67

the need for such facilities and have established industrial finance and development corporations, whose main function is the granting of financial assistance to private industries in acquiring fixed capital. These corporations are generally permitted to underwirte issues of stocks, shares, assets and debentures by industrial concerns and to guarantee issues of loans raised by such concerns.

The Industrial Finance Corporation of India and the Industrial Finance Corporation of Pakistan were established in the year 1948 and 1949 respectively. The I.F.C. of Pakistan is authorised to provide financial assistance to all kinds of manufacturing, mining and power generating enterprises either by granting loans to or subscribing to debentures of industrial concerns. Such loans and debentures ~~being~~ are repayable within a period not exceeding 20 years, by underwriting the issue of stocks, shares, bonds or debentures by industrial concerns as are repayable within a period not exceeding 20 years and are floated in the public market.

It is empowered to grant loans and other financial assistance to all industrial concerns whether incorporated as companies or not. Besides, it is also empowered to assist such industries as have not commenced production, provided the whole or major part of the assets of such concerns have been disposed with a view to commencing production.

It confined its activities to the granting of loans to industrialists as distinct from sponsoring of the industries. It is precluded by its statute from subscribing directly to the shares or stock of any company and as such it was not in a position to assist in the setting up of new industries.

The charter of the Industrial Finance Corporation of Thailand provides that the existence of a Government or other public interest in an enterprise shall not necessarily preclude financing by the bank ~~af~~ if the enterprise, despite that interest is essentially

private in character. The charter also provides that no enterprise shall be considered essentially private in character if the Government or any other Government agency holds directly or indirectly more than 10 per cent of the share capital.[54/]

The I.F.C. of India is concerned only with the finance of large scale industry. It advances loans to companies but rarely participates in their equity capital. The corporation transacts the following kinds of business :

(a) Guaranteeing loans by companies in the open market,

(b) Granting loans and advances and subscribing to debentures. But like I.F.C. of Pakistan, it is not authorised to participate in equities.

Table No. 36

Loans and Advances of Industrial Finance Corporation of India between 1951-52 to 1960-61[55/]

(Lakhs of Rupees)

Year	1951-1952	1955-56	1960-61	1961-62	1962-63	January 1964
Loans and advances	655	1,401	4,074	4,548	5,563	6,594

In recent years the I.F.C. has also undertaken new lines of activities, i.e. underwriting of issues in the share market and the guaranteeing of deferred payments on behalf of industrial concerns to foreign manufacturers of capital goods. The total amount of underwriting approved by the Corporation by 30th June, 1959 was of the order of Rs.162.5 lakhs.[56/] ~~Ts~~ The scheme for guaranteeing deferred payments came into force on 21st December 1957, and in the year 1962-63

54/ Problems and Practices of Development Banks : Shirley Boskey; P.62, I.B.R.D.,(1959)

55/ Reserve Bank of India Bulletin; P.206, No.15, February 1964.

56/ In the year 1962-63 the I.F.C.underwrote jointly with other institutions and/or brokers, seven equity issues for a total of Rs.2.16 crores, as against two equity issues and five preference issues for a total of Rs.41 lakhs in the year 1961-62. See Report on Currency and Finance for the year 1962-63, P.64.

the Corporation approved five applications for guaranteeing deferred payments to the extent of Rs.2.74 crores.[57]

For the first time in 1962-63 since its inception in July 1948, the Corporation approved direct subscriptions to the stock and shares of industrial concerns in terms of Section 23(I)(f) of the I.F.C. Act as amended in December 1960, the amount approved for this purpose during the year being Rs.1.87 crores in respect of two applications.[58]

During 1962-63, although the amount of loans sanctioned by the Corporation was relatively small, the amount disbursed was the largest for any year so far. Loans and advances sanctioned in respect of 40 industrial concerns amounted to Rs.16.31 crores (of which Rs.2.94 crores were in foreign currency) as compared to Rs.25.90 crores (inclusive of Rs.2.22 crores in foreign currency) sanctioned to 46 industrial concerns during the preceding year and the record of Rs.27.48 crores sanctioned in 1960-61. Total disbursements during the year, on the other hand, reached Rs.14.03 crores as against Rs.8.12 crores in 1961-62 and Rs.7.42 crores in 1960-61.[59]

The I.F.C.'s of India and Pakistan have no more than a peripheral role in the drama of economic development, so long atleast as they are expected to behave commercially.[60] This conclusion, however, would not be justified, but it is probably true to say that the purely financial type of agency will fulfil real needs and operate most successfully where first, the private enterpreneurs with state encouragement are actively seeking new outlets and possess the requisite abilities for sound industrial organisation, and second, there is a serious lack of private sources of loan capital upon which such entrepreneurs may draw. Unless both of these conditions are present, the chances are that the I.F.C. will find itself high and dry.[61]

57/ Ibid : Page 65.
58/ Ibid : P.64,65
59/ Ibid : P.64
60/ Public Enterprise and Economic Development : A.H.Hanson; P.254
61/ Ibid.

The Industrial Development Bank of India (IDB)[62] is the latest in the series of specialised institutions set up since independence to provide term credit to industry. The IDB has got a wide field and will provide finance to manufacturing, mining, processing and service industries both in the private and the public sectors and incorporated under the Companies Act or any other law.

The role of the IDB extends beyond the provision of financial and other assistance to industrial concerns. The Bank can undertake promotional activities such as marketing and investment research and surveys as well as techno-economic studies. It can also provide technical and administrative assistance to any industrial enterprise for promotion, management or expansion. Above all, it has been assigned a positive role in the process of industrialisation through planning, promoting and developing of new industries to fill the gaps in the industrial structure of the country.

When the I.F.C. of India was set up, the Government thought of establishing separate financial corporations in the states. The Union Government passed the State Financial Corporation Act on September 28, 1951, empowering the states to establish financial corporations. They now exist in all the states. Their share capital is subscribed by the state Government, the Reserve Bank of India, scheduled banks, cooperative banks, insurance companies, and the other financial institutions. The public is empowered to subscribe to their share capital to the extent of 25 per cent. Each state corporation is authorised to provide financial assistance by granting loans or advances or subscribing to debentures of industrial concerns, repayable within 20 years and underwriting the stocks, shares, bonds and

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62/ For details see Reserve Bank of India Bulletin, PP.641 to 644 May 1964.

debentures subject to their being disposed of in the market within seven years. The scope of the activities of State Financial Corporations is wider than that of Industrial Finance Corporation inasmuch as the former provide finance to public limited companies, the private limited companies, partnership concerns and the proprietary concerns. The Corporations are, however, prohibited from subscribing directly to the shares or stock of any company having a limited liability, except for underwriting purposes, and granting any loan or advances on the security of their own shares. The Corporation does not grant assistance exceeding 10 per cent of the paid up capital of the corporation or Rs.10 lakhs, whichever is less, to any single industrial concern.

In pursuance of the amendments to the State Financial Corporations Act which came into effect from April 16, 1962, the facility to borrow from the Reserve Bank for periods upto 18 months and from the Refinance Corporation for industry have begun to be utilised. Limits of Rs.2.4 crores were sanctioned by the Reserve Bank to four Corporations and Rs.35 lakhs were outstanding at the end of June 1963. The Refinance Corporation also advanced medium-term credit of Rs.97 lakhs to two corporations and Rs.141 lakhs to the Madras Industrial and Investment Corporation. Four other Corporations also augmented their resources by bond issues. The enhanced limit, viz., Rs. 20 lakhs upto which the Corporation can now assist the public limited and Cooperative concerns appears to have been utilised in a number of states and this is reflected in an appreciable rise in the loans sanctioned and disbursed during the year.

Loans and advances sanctioned by the State Financial Corporations during 1962-63 (Rs.18.33 crores) were appreciably larger than ~~that~~ those in the preceding year (Rs.12.9 crores) and so were total disbursements (Rs.11.33 crores as against Rs.8.07 crores).[63]

63/ Report on Currency and Finance for 1962-63, P.65

The experience of the last decade seems to indicate that while the impediments in the way of a quick expansion of the range and volume of activities of SFCs are many, the major ones are (a) lack of adequate resources, (b) lack of suitable climate for undertaking underwriting business, (c) excessive caution owing to inability to build up adequate reserves and (d) the implications of the scheme of guaranteed dividends as applicable to the corporations. That these corporations had no foreign exchange resources of their own ~~have~~ have also contributed to limit in some measure their business. Another reason for slow progress in advances to small-scale units was that the matter was being handled by the National Small Industries Corporation which had been supplying machinery on hire purchase. Apparently this form of finance was found more convenient by this sector than loans on mortgage security. It is, therefore, essential that certain further measures of positive assistance should be accorded to these corporations if a broad based pattern of industrialization is to be achieved within a reasonable time. The Corporations have been set up to cater to the needs of the relatively weaker sector of industry viz., the medium and small sized sector and they, therefore, could justifiably claim more assistance than that given to the bigger financial institutions meant to cater for large scale industries.

Further, the deposits collected by the Corporations still remain very low. It is only the Madras Industrial Investment Corporation which has been able to raise an appreciable amount by offering rates of interest considerably above those offered by the others. Governments have recently decided to augment the resources of the Refinance Corporation for Industry and this will no doubt help the flow of funds to these Corporations. The establishment of the proposed Development Bank announced by the Finance Minister is also likely to be of assistance in this respect.

The working results of State Financial Corporations for 1962-63 have been generally satisfactory, but in Corporations functioning in the industrially less developed areas, certain overdues have begun to be noticed. It will need to be carefully analysed how far such defaults reflect the shortage of raw materials, power or transport which have often compelled industrial concerns to operate at substantially below their rated capacity, or how far ~~is it~~ it is the result of injudicious lending. Maintenance of close contact with the borrowers after the loans have been disbursed so as to give them necessary help and advice at each stage of the fruition of the project for which finance has been provided is likely to go a long way towards keeping down the number of defaults.

One of the noticeable features of Development Banks abroad seems to be the relatively greater freedom enjoyed by their management in deciding upon the nature of security which borrowers must furnish for term loans. In India also, it is now appropriate that similar freedom should be accorded to their management. There is, of course, no doubt that a relaxation should not lead to the employment of resources into risky channels, jeopardising the safety of the funds of the state and of bond holders. On the other hand, one factor which should be taken into consideration now is the introduction of the Government Credit Guarantee Scheme which was not there when the ~~SFCs~~ SFCs Act was enacted. SFCs have not made much use of this scheme. This scheme seeks to cover the risks of lending to a considerable extent and may, therefore, if taken proper advantage of, justify a judicious relaxation of the restrictive provisions of SFCs Act.

The Refinance Corporation of India was registered in June 1958 as a private limited company under the Indian Companies Act, 1956 to augment the resources available for the use of medium sized industrial units in the private sector through established banking channels. But effective from March 28, 1961 the Corporation became a public limited

company in terms of the new Section 43 A introduced by the companies (Amendment) Act, 1960.[64/] Shares of the face value of Rs.12.5 crores were issued to the Reserve Bank of India (Rs. 5 crores), the State Bank of India (Rs.2.3 crores), the L.I.C., (Rs.2.5) crores, and 14 larger scheduled banks (2.7 crores) on which 10 per cent was paid on application and a further 10 per cent on allotment. The Government of India had agreed to place with the Corporation a sum of about Rs.26 crores as an interest bearing loan of 40 years.

The loans of Refinance Corporation are eligible to those concerns whose paid up capital and reserves, excluding reserves for payment of taxes and normal depreciation reserves do not exceed Rs. 2½ crores. The maximum amount of loan to any one borrower is not to exceed Rs. 50 lakhs. The Refinance Corporation grants refinance facilities through the member banks whose initial quotas have been fixed, but which are to be reviewed from time to time. The period to which these facilities are available varies between three and seven years.

With a view to enlarging the activities and imparting flexibility to its operations, the Refinance Corporation for industry introduced in 1960-61 important operational changes in its scheme of refinance. Thus, the refinancing facilities, which hitherto were confined to 15 member banks have now been extended to 43 additional banks, 15 state financial corporation, and three state cooperative banks, without requiring them to become shareholders of the corporation.[65/] The corporation in exceptional cases, has decided to consider loans for a longer period upto 10 years as against three to seven years, and also loans to industrial units with capital and reserves above Rs.2½ crores. Further, the corporation has extended the list of industries eligible for refinance loans to include industries other than those listed for development in the private sector in the second and subsequent five year

64/ Ibid : P.35
65/ Ibid : 1961, P.35

Plans. It has also decided to refinance loans made to small scale industries, provided such loans are eligible under the refinance scheme and are guaranteed under the Government of India scheme for the guarantee of advances to small scale industries.

These changes have brought about substantial changes in the loan operations of the corporation. It received, during 1962-63, 116 applications for Rs.17.99 crores as against 74 applications for Rs.12.20 crores in 1961-62, and sanctioned 86 applications for Rs.13.5 crores as against 60 applications for Rs.10.61 crores during the preceding year. The amount disbursed during the year was also appreciably larger at Rs.8.21 crores as against Rs.5.75 crores disbursed during 1961-62. Since its inception in June 1958 to end March 1963, the corporation received 244 applications for Rs.40.04 crores, of which it had sanctioned 190 applications for Rs.31.79 crores. Aggregate disbursements amounted to Rs.17.79 crores, ~~at~~ of which Rs.16.13 crores were outstanding as of March 31,1963.

Even more important than the increase in operations was the considerable expansion of the scope of the Corporation's functions to bring it into more intimate relationship with developmental efforts at two crucial points.[66/]

Firstly, in pursuance of its decision to refinance medium-term export credits, the Corporation introduced during the year 1963 a scheme which came into force from January 1, 1963. Under the scheme the refinance facilities for periods exceeding 6 months but not exceeding 5 years will be ordinarilly extended in the case of certain specified capital or engineering goods. Under the scheme, the minimum amount of a loan in respect of which refinance may be sought has been fixed at Rs. 1 lakh for the time being and the total amount of export credits to be

66/ See Reserve Bank of India Annual Report for 1963, PP.32,33 and also Report on Currency and Finance for the year 1962-63, P.68.

refinanced in respect of any one exporter is not to exceed Rs.50 lakhs. The rate of interest at which these refinancing facilities will be made available to banks has been fixed lower at 5 per cent as against the current rate of 5½ per cent for refinancing of industrial loans.

The other new line of activity entrusted to the Corporation is the administration of the Guarantee Scheme devised by the Government of India to facilitate the utilization of the loan of $ 35 million from the IBRD for the Coal Industry in the private sector. Earlier the Corporation had agreed to extend its refinancing facilities to banks etc., giving rupee term loans to mining units which were eligible for this loan.

The new guarantee scheme, which came into force from April 9, 1963, confers a substantial protection on the banks, as losses arising in these advances will be shared between them and Government in the ratio of 35 : 65.

The Industrial Credit and Investment Corporation of India[67/] which started operating on January 5, 1955 is a privately sponsored institution. It has been established with the objective of assisting industrial enterprises within the private sector of industry in India in general by : (i) assisting in the creation, expansion, and modernization of such enterprises;(ii) encouraging and promoting participation of private capital, both internal and external, in such enterprises and (iii) encouraging and promoting private ownership of industrial investment and the expansion of investment markets. In particular (a) it is to provide finance in the form of long and medium term loans or equity participations (b) it is to sponsor and underwrite new issues of shares and securities, (c) it is to guarantee loans from other private investment sources, (d) it is to make funds available for reinvestment by revolving investments as rapidly as prudent, and (e) it is to furnish managerial, technical and administrative advice and assist in obtaining managerial, technical, and administrative services to India industries.

67/ Report on Currency and Finance 1954-55, PP.50 and 51

The I.C.I.C. of India during the eighth year of its working, recorded a further significant advance in its operations, the magnitude of financial assistance approved as well as disbursed during the year reaching an all time high. The Corporation approved during 1962, assistance for a total of Rs.19.6 crores (gross) in respect of 56 companies as against an amount of Rs.13.76 crores (gross) in the preceding year. Of this, rupee assistance in the form of loans, underwriting of, and direct subscriptions to, ordinary and preference shares and debentures, accounted for Rs.9.83 crores (or 50 per cent of the total assistance approved) and loans in various foreign currencies for the balance of Rs.9.77 crores. The amount disbursed during the year, including disbursements in various foreign currencies, totalled Rs.9.85 crores as against Rs.5.95 crores in 1961.

The Corporation during the year 1962 completed seven underwriting operations for a total amount of Rs.2.42 crores as against five operations for a total of Rs. 78 lakhs in 1961. It further augmented its foreign exchange resources by procuring from the World Bank a third line of credit of U.S.dollar 20 million (Rs. 9.52 crores), the first two of U.S.dollars 10 million each having been obtained in 1955 and 1959. A loan of U.S.dollar 5 million (Rs.2.38 crores) has also been sanctioned to the corporation by the U.S.Development Loan Fund. The Corporation negotiated a fifth line of credit of $ 30 million from the World Bank and another line of credit of D.M. 20 million, besides the one for D.M. 5 million under negotiation from the Reconstruction Loan Corporation of the Fedral Republic of Germany.68/

The Pakistan Industrial Development Corporation started functioning on June 12, 1952.69/ It was set up to overcome the shyness of private enterprise and to establish more important industries in

68/ Reserve Bank of India Annual Report, 1961, P.36 and 1963; P.34

69/ " Industrial Development Corporations of India and Pakistan" , Dr. Om Prakash, The Economic Journal; (London) P.40, March 1957-Vol. LXVII, No.265.

the country and to work in collaboration with private capital wherever possible. The corporation sponsors public limited companies in which participation of private capital is not forthcoming, the corporation gets the total capital from the Government to establish industry without loss of time.

The primary aim of the corporation is to attract private enterprise to the maximum extent and, therefore, where the corporation fails to attract private enterprise in the initial stages, it will be the corporation's endeavour to transfer to private enterprise as large a share as possible. The Corporation is encouraging to the maximum possible extent the flow of private capital into industries, supplying the deficit where necessary and providing the technical skill and managerial experience necessary for heavy industries. In terms of technical know-how, the Corporation has at its disposal, besides the services of its own officers, the services of two U.N. technicians.

The Corporation has a two fold effect on the economy of the country. It will provide the country with such essential industries as may make it self-sufficient in its essential requirements within a reasonable time and will also attract private capital, which has so far been shy in industrial investments.

The State Bank of Pakistan sponsored a scheme for the creation of the Pakistan Industrial Credit and Investment Corporation,70/ which came into existence in 1957. Its paid up capital is Rs.20 million, of which 40 per cent has been subscribed by the foreign investors, other resources of the Corporation consist of an interest free advance of Rs.30 million by the Central Government and loans totalling $ 28.4 million from the International Bank and the U.S.Development Loan Fund. More than 80 per cent of its resources thus consist of foreign exchange.

70/ Central Banking in South and East Asia: S.G.Davies,P.166, (1960)

The Pakistan Industrial Credit and Investment Corporation which cannot afford to make small loans directly, plans to rediscount the paper of clients of the Government sponsored Small Industries Corporation with the latter's guarantee. Besides, the Corporation together with an American firm has sponsored a company to finance small industrialists on a participation basis. 71/

It does not prefer to finance working capital needs directly. But, when funds for permanent working capital cannot be raised elsewhere, this on occasion provides such funds indirectly by financing a somewhat larger proportion of fixed asset capital requirements than is their normal practice. 72/ It is expected that on an average approximately Rs. 50 to 60 million will be invested annually in private industry through Pakistan Industrial Credit and Investment Corporation. 73/

By March 1959, within the short period of less than one and a half years, the Corporation has sanctioned loans of a total amount of Rs. 48.2 million, of which Rs. 33.8 million or roughly 70 per cent were the foreign exchange. 74/

Table No. 37

Loans Granted by the Rural Banks of Philippines classified by purpose. 75/
(1953-1959)

(As Percentage of the Total)

Year	Total amount in thousand Pesos	Agricultural	Commercial	Industrial	Others
1953	2796	66.3	28.5	4.1	0.9
1954	4625	65.2	24.1	2.6	7.9
1955	6719	68.3	20.0	2.7	9.4
1956	18,144	63.7	25.8	4.7	5.6
1957	35,913	67.5	27.3	2.2	4.8
1958	51,140	70.5	23.5	3.4	2.4
1959	61,643	71.8	23.3	3.2	1.8

71/ Problems and Practices of Development Banks : Shirley Boskey, PP.60 & 61, I.B.R.D.,(1959)

72/ Ibid : 69

73/ Outline of the Second Five Year Plan of Pakistan (1960-65), P.14, Government of Pakistan, January 1960.

74/ Central Banking in South and East Asia; S.G.Davies; P.166, 1960

75/ Statistical Bulletin; Central Bank of Philippines; P.72, Vol. XI, No.4, December, 1959.

Table No. 38

Loans Granted by the Development Bank of Philippines (1947-1959) 76/

(As Percentage of the Total)

Year	Percentage of Industrial Loans	Year	Percentage of Industrial Loans	Year	Percentage of Industrial Loans
1947	27.5	1952	35.9	1956	33.8
1949	26.9	1953	37.0	1957	31.4
1950	43.0	1954	25.0	1958	25.0
1951	46.7	1955	25.0	1959	52.6

Loans granted by the Development Bank of Philippines to Industrial concerns accounted for 27.5 per cent in 1947 and 46.7 per cent in 1951. They accounted for 52.6 per cent in 1959.

The Loans granted by the Agricultural and Industrial Credit Corporation of Ceylon 77/ in 1944-45 accounted for 0.19 per cent. In 1951-52 and in 1952-53, they accounted for 1.95 per cent and 2.17 per cent respectively. In 1954-55, they declined to 0.3 per cent. Thereafter the industrial loans of the Corporation accounted for 1.10 per cent, but again declined to 0.63 per cent in 1962-63. Thus the loans given by the corporation for industrial purposes have shown wide fluctuations.

Table No. 39

Development Finance Corporation of Ceylon Financial Operations. 78/

(Rupees in Thousand)

Period	Loans granted during the period	Equity investments in Development Projects	Total Loans and equities outstanding at the end of the period
May 1956 - March 1957	560	441	1,001
April 1957 - March 1958	5,275	304	6,395
April 1958 - March 1959	3,206	913	9,983
April 1959 - March 1960	5,342	1,030	15,520
April 1960 - March 1961	4,293	463	19,359
April 1961 - March 1962	2,884	400	20,971
April 1962 - March 1963	3,481	400	23,166

76/ Ibid : P.81
77/ Cit. Op., P.85, Table No.25
78/ Central Bank of Ceylon, Annual Report, 1963, Table No.13

The Development Finance Corporation of Ceylon set up in 1956 authorises the bank to provide finance in the form of long term or medium term loans with or without security or by purchasing or subscribing for shares or other securities or by acquiring any other asset.[79/] Between May 1956 and March 1957, it granted loans amounting to Rs. 560 thousand, while its equity investment in development projects accounted for Rs. 441 thousand. Between April 1952 and March 1963, the total loans granted by the Corporation accounted for Rs. 3,481 thousand while equity investment in development projects accounted for Rs. 400 thousand.

In China-Taiwan a development corporation was organised in the spring of 1959, under private control, though the Government is a shareholder in that. Another mixed bank under private management was set up in the Federation of Malaya. In late 1959, a privately owned development bank was set up in Thailand as successor to a Government institutions.[80/]

The Bank for Industry set up by the Government is to provide long term loans for industrial purposes at relatively low rates ~~an~~ of interest......Recently the Board of Investment was established in Thailand, which has been given wide powers to assist in promoting new industries and in improving the existing ones. This organisation is to play an important role in the industrial development of the country.[81/]

In India, the Investment Trusts have come into existence only recently and the progress which they have made so far is insignificant. The reasons for their late development lie basically

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79/ Problems and Practices of Development Banks : Shirley Boskey; P.70, I.B.R.D., 1959
80/ Ibid : P.9
81/ The Economy and National Income of Thailand : Bundhit Kantabutra : PP.12,13, Bangkok, September, 1959.

in the low volume of savings available for investment, as also partly in the absence of adequate investment outlets conducive to the promotion of investment trusts. " By March 1957, there were 619 investment and Trust Companies with paid up capital of 37.2 crores. Of these, the number of public limited companies was 233 with paid - up capital of Rs.26.7 crores. As of March 1959, the total of both public and private limited Investment and Trusts Companies was 595 with paid up capital of Rs.37.7 crores, as compared with 122 companies with paid up capital of Rs.15.2 crores in March 1936." 82/ Therefore, with their relatively small resources and even the limited resources not channelled fully into stock exchange investments, Investment Trusts in India , unlike Trusts elsewhere, especially in U.S. do not for all practical purposes, count among institutional investors in Indian capital market.

The Investment Trust Companies have not made generally investments of a significant order. " Only in a few cases the investments exceeded the rupee one crore level each. The investment of the 32 companies taken together accounted for over Rs. 15 crores. The investments of these companies were mostly in ordinary shares and excepting a few prominent ones, Investment and Trust Companies have not engaged in underwriting of new issues." 83/

In India, several of the Investment Trusts do not function as independent Investment Trusts in the true sense of the term. Being closely associated with the managing agency houses, investment and Trust Companies in India have been made use of in many cases to finance or control companies in which the managing houses were

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82/ Reserve Bank of India Bulletin : October, 1960, P.1462
83/ Ibid : P.1463

interested.[84/] Therefore, the basic objective of an Investment Trust, namely the independent selection of investments purely on merits with due regard to safety and diversification is not served.

To mobilise and canalise savings of small investors in India, it is necessary to introduce a measure of regulation of the unit trusts in India. In U.K. and U.S.A., where relatively small investor can be expected to be more alert and enlightened in matters pertaining to investments in stocks there is special legislation regulating the working of the Unit Trusts and Investment Companies in important respects. In India, there should be minimum legislation to provide for (1) adequate diversification of the investment portfolio, (2) a ceiling in regard to investments in one security, (3) ceilings on managerial and other remuneration paid to management, (4) furnishing of annual reports and auditing of accounts etc.

However, it may be pointed out that the development of the Unit Trusts cannot take place without the availability of an adequate number of sound securities in the security markets. ~~For~~ The diversification of the portfolio investments of the Unit Trusts and the avoidance of duplication of investments as among the various Unit Trusts depend on the above factors.

The establishment of the development corporations in the South East Asian countries is an indication of the widespread recognition that economic progress in the underdeveloped countries requires concerted public action on an increasing scale. Such operations should include both planning and operations. Development Corporations are the tools the services of which the underdeveloped

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84/ Ibid : P.1462

countries should utilise in distributing the limited resources most effectively to accelerate the process of economic growth. ~~in these countries.~~ One of the advantages of these organisations is that they offer the possibility of making available a pool of resources for use in several fields.

To avoid duplication, the finance corporation should undertake only such financial operations as are not undertaken by the banks and other financial institutions. The Corporation should meet the long-term and medium term requirements of industries arising from the expansion or replacement of fixed capital.

The principles on which loans are granted should be given due consideration so as to ensure the safety of funds. This requires a trained technical staff. The growth of the corporation device in the underdeveloped countries is necessary to give a phillip to the growth of large scale and medium industries particularly in respect of the provision of the medium and long-term credit facilities for industries and also for promoting the capital market.

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CHAPTER IV

DEFICIT FINANCING

Concept of Deficit Financing

In U.S. the excess of expenditure over current revenue receipts constitutes deficit financing. According to this view, the coverage of the budget gap through loans also constitutes deficit financing. In the Indian sense, budget deficit is recognised when the Government spends more than it receives from the public in taxes, fees, borrowings, etc. The deficit is met by utilising the cash balances with the Reserve Bank and or by resorting to short term loans from the Reserve Bank. Thus the total deficit spending is equal to the difference between public expenditure on the one hand and tax and non-tax revenue including the profits of public enterprises on the other. Pure deficit is that part of total deficit, which is based on the creation of new money and not on the transfer of purchasing power from the public to the Government through public borrowing. Hence all public outlays based on drawing down the past accumulated Government balances and borrowings from the Reserve Bank of India and the commercial banks through sale of securities through them is termed as pure deficit.

The commonly used concept of deficit financing in Ceylon[1/] is the sum of the net receipts from Government's lending and borrowing operations and the decrease in its cash balances. This shows a change in the net worth of Government reflecting the change in its balance sheet position, and is broadly the same as the net cash operating deficit. This concept is of particular significance in most of the South East Asian countries because " inflationary and deflationary tendencies in them are closely associated with the increase and decrease in the money supply. This deficit is equal to the total of the net decrease in

1/ Central Bank of Ceylon Bulletin, P.20, October, 1955

Government's rupee cash balances and the net increase in the volume of the Government debt held by the banking system.[2]"

According to the Second Five Year Plan of Pakistan, deficit financing is indicated by change in some key factors in relation to money supply. The increase in money supply should be consistent with price stability. It depends on, (1) an increase in national output, (2) an increase in the monetisation of the non-monetised sector and (3) the increase in demand for cash balance by firms and ~~indiv~~ individuals. The safety limit of an increase in money supply applies to the whole economy. The Government's non-inflationary deficit financing has to be arrived at by deducting from the total the likely monetary expansion in the private sector. This limit is not rigid but flexible and the need for liquidity must be assessed from time to time in the light of current inflationary or deflationary tendencies.[3]

In the American sense, loans from the public not exceeding genuine savings would put idle public savings into active use. They would be non-inflationary and would merely substitute public for private expenditure.

In the Indian sense, deficit financing would ensue when the budgetary gap, including receipts from taxes and borrowings, is covered by loans from the Reserve Bank of India or the cash balances with the bank are utilised. In fact, to assess the effects of deficit financing, public debt held by the Reserve Bank and the commercial banks should be taken into consideration.

The Government may use its cash balances with the Reserve Bank or obtain loans from it. It makes use of the newly created money in both cases and spends it. The Reserve Bank does not get the money from any body else while paying money to the Government. Thus the net

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2/ Ibid
3/ Government of Pakistan, Second Five Year Plan; PP.61,62.

borrowing from the Reserve Bank and the net fall in Government's reserve balances measure the amount of deficit incurred by the Government during the year.

In deficit financing, the main point is not merely the newly created money, for that is just equal to the budget deficit. What is important is the addition caused to the community's spending power. Government receipts reduce the spending power of the community and Government disbursements add to it. But there are exceptions to it. First, foreign receipts and disbursements do not affect the spending power of the community. Second, certain domestic transactions also do not influence the spending power of the community.[4] Hence a budget deficit need not necessarily cause an equal addition to the community's spending power by increasing the demand for goods and services.

In assessing the risk of deficit financing three main factors are to be considered. The first is the economic situation of the country. When trade is slack and there is unutilised capital equipment, an increase in spending power is not inflationary. In industrial countries there is unutilised capital equipment, but in underdeveloped economies, there is generally scarcity of savings or real resources. Of course, unskilled labour is in abundance in underdeveloped countries. Second, the productive expenditure in the budget should be taken into consideration, because it adds to the spending power of the community; but it is in a class by itself. (a) It widens employment opportunities by bringing unemployed resources into use. (b) It augments the revenue and borrowing capacity of the Government which means that in future the

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4/ For instance, Government may make a grant or an interest free loan of Rs.40 crores to the Industrial Finance Corporation of India and to the Investment and Credit Corporation Ltd., to be used in emergency. This is an expenditure for Government, but it does not add to the community's spending power till the emergency arises. Similarly, the redemption of loans held by commercial banks increases their resources, but the spending power of the community increases only when the banks use the increased resources by making loans to their customers.

Government would meet its expenditure with smaller deficit.

(c) Productive expenditure augments capital stock, cheapens production and thus the present inflationary budget has potential anti-inflationary tendencies.

Finally, the Government policy in the non-budgetary sphere has to be taken into view. The foreign trade policy, monetary and credit policy, and the policy of physical controls have to be considered in dealing with x deficit financing. An excess of imports over exports would offset the additional spending power created by budget deficits, but this requires foreign exchange reserves through favourable trade balance or through credit abroad. Again, the monetary and credit policy has to be directed to control inflation which in India was rendered possible through an amendment of the Reserve Bank of India Act under which the proportional reserve system yielded place to the minimum reserve method and the Reserve Bank has been empowered to vary the cash reserves of the banking system. Finally, commodity controls have to be used to check inflation.

The following types of deficit financing are non-inflationary.:

Firstly, sterling may be purchased by the Government against its cash balances with the Reserve Bank of India to finance imports of equipment for the public sector. This would reduce the assets and liabilities of the Reserve Bank of India to the extent of sterling purchased, but the volume of money in circulation would remain unaffected. Sterling may also be purchased against ad-hoc treasury bills when there ~~wi~~ would be no change in the assets and liabilities of the Reserve Bank of India. The drawing down of cash balances would match the drawing down of sterling balances.

Second, the cash balances with the public may be utilised for economic development. With an expansion in the monetised sector production would increase and vice versa. Cash balances of the public

represent the real resources which may be utilised through deficit financing. A part of the real resources of the public would be used for the private sector. Commercial banks would provide the necessary finance. Cash balances would grow with an increase in individual real incomes and the scope of deficit financing or credit creation would grow.

Inflation is ~~thx~~ thus the main risk of deficit financing. With a rise in prices, food and clothing may become dear and cost of living may rise, which may increase the cost of production leading to a demand for a rise in wages. It may thus create a vicious circle of rising costs and prices. This may upset the calculations regarding the financial resources.

Deficit financing is one of the ways to achieve economic growth. Monetary investment is necessarily meant to serve as a combining force which could pull together various productive abilities for further production. If it does not serve this purpose, it would be fruitless and this would be very dangerous if such monetary investment were done with created money income, for it could cause all dangers that would result from inflation. There are a number of factors which, if not controlled or are not favourable, could dissipate the effectiveness of deficit amount, the direct result of which is inflation.5/

Inflation may be checked through increase in the production of essential consumer goods and through imports. The latter depends upon the position of foreign exchange resources. Planning should increase production which in turn should lead to a reduction in the non-monetary sector. This would require a large money supply which is produced through deficit financing; but it would not be proper to depend on this factor in the short run. Further, deficits need cause no concern, "if they should be declining in relation to the size of development outlay itself over a period of years, for, then the

5/ " Some limitations of Deficit Spending" - Joseph E. Mathai : P.56, The Indian Journal of Economics, No.156-Vol.XXXX, July 1956.

counter-inflationary forces of increased production may be more effective and price stability will not be seriously endangered.[6/] The

scope of deficit financing is less in underdeveloped countries than in industrially advanced countries. In the latter, there are unutilised capital resources which deficit financing can help to utilise, but in underdeveloped economies there is untrained labour. Hence the time lag between credit creation through deficit financing and the production of goods and services is likely to be longer in an underdeveloped economy like that of India. Here full employment of other resources may be quite consistent with the existence of a large unskilled labour force which cannot be employed because of the inadequacy of capital. Hence according to the taxation enquiry commission, " the limits of deficit financing, which is not to result in serious inflationary consequences, are.....likely to be reached earlier here than in the advanced industrial economies. We cannot, therefore, but underline the need for the utmost endeavour to enlarge the role of taxation and borrowing in the financing of the development programme of the public sector, and to minimise the role of deficit financing especially in the longer period following the First Five Yeal Plan."[7/]

There are, however, two types of situation where a Government deficit, leading to an increase in money supply, would be quite consistent with the objectives of economic growth and stability.[8/] It is, for instance, possible to consider a part of the expansion in money supply as monopoly profits; which are "taxes" according to fiscal terminology, since the Government can alone issue money or it may be

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6/ Report of the Taxation Enquiry Commission; Government of India; 1953-54, P.96-Vol.II.

7/ Report of the Taxation Enquiry Commission, Government of India, 1953-54, P.96, Vol.II.

8/ U.N., Economic Survey of Asia and Far East (1960) P.106

considered as a voluntary gift to the Government from the community. To the extent that a community at a given time is willing to hold a large volume of liquid money, either in response to an increase in the monetised sector of the economy or to a rise in the national levels of economic activity, the goods and services obtained by the Governments in initially issuing money become a free gift to it. Predicting such an increase in the demand for holding money, planning authorities in Burma, Ceylon, India, and Pakistan have counted a certain amount of monetary expansion among the financial resources for their plan outlays.

The second case is provided by short term situations where a fall in money incomes arising from deflationary conditions in domestic and foreign trade is counteracted by money creating budget deficits. India, for instance, experienced certain recessionary tendencies in the economy towards the end of its First Five Year Plan. The Government thereupon decided to increase the rate of development expenditure and money creation on Government account in the fourth year (1954-55) of the plan, mainly to compensate for the inadequacy of effective demand in the economy. There was, in this case, no conflict between the short term policy of stability and long range goal of development.

Budget Deficits

The countries of the region in their attempts to use fiscal policy for directly augmenting the proportion of productive expenditures in the economy had to face the basic problem of rising pressures of demand on the limited resources base. This has been generally reflected in budget deficits in a number of countries. The major exception is Mainland China where surpluses were recorded in all years between 1953-58, with the exception of 1956. The magnitude and the trends of budget deficits in the countries have been caused by the developments and the policies affecting Government expenditures and revenues. Only in Ceylon, Malaya and Philippines the deficits were

smaller than one-third of Government outlay.

Table No.40

Budget Deficit in a few selected countries (1953-1958) 9/

(Percentage of the Government Expenditures)

Country	1953	1954	1955	1956	1957	1958
Burma	11	26	15	42	20	31
Ceylon	14	-10	-11	- 3	10	11
China Mainland	- 1	- 6	- 1	6	- 7	- 2
China Taiwan	27	27	30	28	32	34
Federation of Malaya	28	26	8	12	12	22
India	20	24	29	31	33	36
Indonesia	13	23	13	8	20	34
Laos	29	43	63	58	42	64
Pakistan	20	29	14	21	38	30
Philippines	14	6	9	15	5	4
Thailand	26	27	23	15	26	17
Vietnam	29	68	67	-	40	-

In many countries during the post-war period budget deficits, inter alia, contributed to inflationary conditions. The persistence of inflationary conditions affected also the balance of payments and vice versa. Where foreign trade was free of controls, inflation increased imports and adversely affected exports resulting in balance of payments deficits. However, such an outlet was available only to a few countries. In most countries import reductions only strengthened the inflationary forces let loose by the increase in non-consumption spending. 10/

The deficiencies on the revenue side were compounded by problems on the expenditure side. Expenditure grew substantially with the increase in population, urbanisation and growth of the economy. As it is, social services expected from and promised by national Governments of the region also increased. Current Government expenditure continued to grow in response to the demands of a developing economy and a changing

9/ U.N.Economic Survey of Asia and Far East 1960, P.107
10/ Ibid : P.104

society. As a result, deficit financing was relied upon to take care of a substantial part of Government outlats. Borrowing from the central bank combined with secondary credit expansion by commercial banks exercised an expansionary influence on money incomes and effective demand at home. The weight of domestic inflationary pressure varied with the magnitude of budget deficits, the availability of foreign aid or past accumulations of exchange reserves and the employment and effectiveness of countervailing monetary and non-monetary controls.

Impact of Deficit Financing on the Economy

The impact of budget deficit on the national economy depends to a large extent on the method of financing employed. Budget deficits may be financed by domestic borrowing from the public, from commercial banks and from the central bank. Borrowing from the public in the domestic market in so far as it reduces private spending transfers real resources to the Government. Borrowing from the commercial banks would lead to a decline in the liquidity of the banks and should tend to reduce commercial bank lending to the private sector. On this presumption, it is included in borrowing from the public in India. In most of the South East Asian countries, however, the central banks have pledged themselves to support the security markets, so that commercial banks regain their holdings of Government securities as cash. Under such conditions or where banks hold a high ratio of cash to deposits, Government borrowing from commercial banks has the same results as borrowing from the central bank, except that the latter creates a base for secondary expansion of credit.

External Financing of Budget Deficits

Financing budget deficits by foreign exchange holdings of the country or by a net inflow of foreign aid and loans, provides additional means in real resources and creates an offsetting balance of payments deficits. If the Government uses foreign exchange acquired through any

of these means to import goods and services from abroad, there is no increase in effective demand at home. On the other hand, the Government may decide to make purchases in the home market, raising effective demand, which is satisfied by letting an import surplus emerge. This in turn is financed by a decline in foreign exchange reserves. In both forms the financial effect is the same, although in the latter situation effective demand is raised temporarily. In either case the net domestic impact of the budget deficit is reduced by the size of the balance of payments deficit, which may be financed by foreign aid or by running down of foreign reserves.

For some years, the value of foreign grants and loans to the South East Asian countries has a tendency to rise. Relative to their size and population, Cambodia, China Taiwan, Laos, South Vietnam and Nepal are among the largest recipients of foreign public aid. The aid financed most or all of the budget deficits in several years.[11/] Countries like Indonesia, which could not fall back upon foreign assets to offset their budget deficits, experienced inflationary pressures in their domestic economy. Others like Ceylon, maintained fairly stable domestic price levels at the expense of their foreign assets.[12/]

Selected Case Studies of Deficit Financing

INDONESIA

Table No.41

Causative Factors in the Increase in Money Supply and Economic Indices (1953-1959) - (In billion rupiah)[13/]

Item	1953	1954	1955	1956	1957	1958	1959 First half	1959 Third half
1	2	3	4	5	6	7	8	9
Money Creation on account of the Public Sector	+2.45	+3.34	+1.76	+2.27	+5.83	+10.9	+5.06	-2.74
Money Creation on balance of payments accounts	-1.56	-0-27	+1.03	-1.8	-1.02	+ 0.6	-1.6	+2.77

11/ Ibid : P.108
12/ Ibid : P.109
13/ Ibid : P.110

1	2	3	4	5	6	7	8	9
Money Creation on account of credit expansion to private sector	-0.05	+0.43	-1.39	+0.99	+2.24	-0.9	-0.3	+1.37
Miscellaneous	+0.04	-0.03	-0.38	-0.28	-1.53	-0.8	-0.3	-9.03
Change in money supply	+0.88	+2.47	+1.12	+1.16	+5.52	+10.5	-3.0	-7.6
I N D I C E S 1952= 100								
Gross National Product	106	115	118	122	131	127	-	129
Money Supply	112	168	185	203	287	445	490	375
Cost of Living	112	124	158	165	257	302	315	331
(Djakarta) food whole sale prices (Imported goods)	108	134	149	154	209	347	-	-

The rise in budget deficits in Indonesia was largely translated into an increase in the money supply. Beginning with the onset of the post Korean War recession, the Indonesian balance of payments position x had been continuously under pressure. The heavy drain on reserves forced the Government to give high priority to the preservation of external stability in formulating economic policies.

With large magnitudes of budget deficits during 1957 and 1958 financed by monetary expansion the price indices continued to rise in Indonesia, although with a time lag and at a slower pace than the money supply. The situation deteriorated further in 1959. It was not so much a pressure on the balance of payments as a continuing rise in internal prices which was the result of falling imports, domestic business disorganisation, declining production, speculative psychological tendencies leading to capital flight and a steeply rising money supply due largely to mounting budget deficits.

Table No.42

Causative Factors in the Change in Money Supply[14/] and Economic Indices : (1953-59)

(Million Rupees)

Item	1953	1954	1955	1956	1957	1958	1959
Money Creation on account of the public sector	+43	-212	-99	-28	+106	+214	+319
Money Creation on balance of payments account	-133	+343	+219	+20	-209	- 87	-195
Money Creation on account of credit expansion to the private sector	+13	-	- 3	+62	+17	- 15	- 13
Adjustments	+4	-1	-1	-	-1	-10	-10
Change in Money supply	-69	+130	+116	+54	-87	+37	+101
INDICES : 1952 = 100							
Gross National Product	99	102	108	102	109	114	122
Money Supply	93	107	120	127	117	121	132
Cost of Living	99	100	100	99	104	103	104

In Ceylon, the years of export surpluses have been associated with budget surpluses, which nullified the inflationary impact of the export surpluses. Budget deficits have been allowed to be largely offset by balance of payments deficits. This is, however, beset with risks for the economy unless foreign aid becomes available in compensating amounts. In 1959, the budget deficit increased sharply as Government expenditure both on current and capital outlays was stepped up. The resulting increase in the balance of payments deficits was not sufficient to offset fully the impact of the budget deficits. As a result the money supply rose and ~~xx~~ foreign assets fell. The almost continuous fall in the foreign assets reduced them from the level of " Rs.744.7 million at the end of 1956 to Rs.172.7 million at the end of December 1960."[15/]

14/ Ibid : 111

15/ Central Bank of Ceylon Annual Report, 1960, Table 26;

PAKISTAN

Table No.43

Causative Factors in the Change in Economic Indices and Money Supply : (1955-56 to 1959-60) 16/

(MILLION RUPEES)

Items	1955-56	1956-57	1957-58	1958-59	1959-60
Money Supply on account of public sector	+161	+416	+679	+191	-34
Money Creation on balance of payments account	+445	-217	-282	+122	+220
Money Creation on account of the credit expansion to the private sector	+55	-232	-90	-57	+165
Adjustments	-6	+23	+44	-57	-55
Change in money supply	+655	+454	+351	-198	+296
INDICES (1955=100)					
Net National Product	99	105	106	105	110
Money Supply	117	128	137	142	150
Cost of Living	105	115	122	114	124

In Pakistan deficit financing has been tempered by the concern to maintain a degree of stability, although price levels remained under pressure, mainly because agricultural production, particularly food production, did not rise. 17/

The First Five Year Plan of India envisaged safe deficit financing to the extent of Rs.290 crores. The gap of Rs. 655 crores was to be met from further external resources or, in the absence of it, by additional measures of internal taxation and borrowing and from deficit financing. 18/

During the First Five Year Plan period, deficit financing was of the order of Rs.400 crores as measured by the actual net addition to the Treasury bill holdings of the Reserve Bank and the draft on Government cash balances. Of this amount, deficits of Rs.100 crores and Rs.160 crores are estimated to have occurred during the last two years of the Plan. They were smaller than the budget estimates mainly because of a shortfall in Plan outlays. In 1955 the price level showed a fall, but it began to rise after 1956.

16/ U.N., Economic Survey of Asia and Far East 1960; P.114
17/ Ibid : P.115
18/ Report of the Taxation Enquiry Commission-Government of India, 1953-54, P.96, Vol.II

The price trends upto 1956 in India are indicated in the following table.

TABLE NO. 44

Price trends in India[19]

Month	Year	Food articles	Industrial raw materials	Semi manufactures	Manufactured articles	Miscellaneous	General Index
April	1954	381.6	472.1	362.1	320.9	707.4	402.6
April	1955	283.6	398.6	327.8	377.1	511.2	345.4
April	1956	379.5	490.9	395.1	385.1	560.8	408.3

The extent to which deficit financing was to be relied upon during the second plan period depended upon the following factors :

First, unemployed and underemployed resources could be employed more fully to initiate a process of higher income and higher investment. Credit was, therefore, to be taken in advance for the additional savings that would be forthcoming in the future from the larger incomes. Hence some initial credit creation was an essential part of the development programme, but the scope for the use of deficit financing in underdeveloped countries is small.

Second, deficit financing was justified because a larger money supply was to be needed with an increase in income, and with an expansion of the monetised sector as the plan outlay was incurred.

Finally, the apparently larger budgetary deficits of the First Five Year Plan did not produce adverse consequences.

The panel of economists[20] wrote in this context that 'deficit financing is thus not necessarily always dangerous; it is the timing and magnitude of it that is of crucial importance. Deficit financing undertaken while the economy is already under inflationary pressure, or in such volume as will rapidly generate inflationary effects, has to be avoided'.

19/ Report on Currency and Finance for 1955-56, Statement 19
20/ Framework of the Second Five Year Plan of India : PP.134 and 125

The panel of economists had suggested deficit financing in the Second Five Year Plan to the extent of Rs.200 crores annually or Rs.1,000 crores for the whole plan period. Any indications of inflationary pressures were to be met by timely and suitable action to keep the same under check. They had suggested financial and physical controls and they were of the view that the situation should in any case be re-examined at the end of the second year or at the midpoint of the Plan period.

The Second Five Year Plan envisaged deficit financing to the extent of Rs.1,200 crores out of a total expenditure of Rs.4,800 crores in the public sector. But the actual deficit incurred over the Plan period accounted for Rs.1,175 crores out of the total actual Plan outlay of Rs.4,600 crores. Below is given the yearly Plan outlay and the amount of deficit spending between 1956-57 to 1960-61.

Table No.45

Yearly Deficit Spending in India's Second Plan.[21/]

Period	Accounts	Rupees in Crores		Percentage
		Plan outlay	Amount of deficit financing incurred	
1956-57	Actuals	634	253	40
1957-58	Actuals	882	496	56
1958-59	Actuals	998	136	1.3
1959-60	Likely Actuals	1,006	127	1.2
1960-61	Likely Actuals	1,080	163	1.5
TOTAL : 1956-57 to 1960-61		4,600	1,175	100.0

Thus during the first two years of the Second Plan deficit financing accounted for a larger percentage of the total Plan outlay.

21/ Prepared from the report on Currency and Finance : 1959-60, P.63

Table No.46

Price Trends in India from 1955-56 to 1962-63 (Base 1952-53 = 100) 22/

Items	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61	61-62	1962-1963
All commodities	92.5	105.3	108.4	112.9	117.1	124.9	125.1	127.9
Food Articles	86.6	102.3	106.4	115.2	112.0	120.0	120.1	126.1
Industrial Raw Materials	99.0	116.0	116.5	115.6	123.7	145.4	142.6	136.5
Manufactures	99.7	106.3	108.1	109.4	111.7	123.9	126.6	128.8
Finished Products	99.6	105.6	109.2	109.1	11[illegible].3	122.8	124.6	127.1

The index of food articles rose by about 39.5 points between 1955-56 and 1962-63, that for industrial raw materials by about 37.5 points, and that for all commodities by about 35.4 points.

Table No.47

Trends in Money Supply : 1950-51 to 1963-64 in India 23/

(Crores of Rupees)

	1951-52	1955-56	1960-61	1961-62	1962-63	1963-64
Money Supply with THE public	1848.13	2216.9	2868.5	3045.7	3316.97	3752.9
Variations in money supply with the public	-169.43	+262.5	+148.4	+177.2	+271.32	+435.9

The increase in money supply in the year 1962-63 was of the order of Rs.+ 271.32 crores, while in 1963-64, it was + Rs.435.93 crores.

Table No.48

Trends in Scheduled Bank Credit in India (1951-52 to 1963-64) 24/

(Crores of Rupees)

Period	1951-52	1955-56	1960-61	1961-62	1962-63	1963-64
Total Scheduled Bank Credit	580.45	761.25	1319.54	1407.61	1588.01	1814.57
Variation in Scheduled bank credit	-	-	+191.66	+88.07	+180.40	+226.56

Scheduled bank credit rose by Rs.191.66 crores over the year 1960-61. In 1961-62 it rose by Rs.88.07 crores and in 1963-64 the corresponding rise was of the order of Rs.226.56 crores.

22/ Ibid : Statement 8; 1962-63.
23/ Reserve Bank of India Bulletin, Table 17, P.521; April 1964
24/ Ibid : Table No.3, P.505, April,1964.

The scope of deficit financing in the Third Five Year Plan was envisaged in the light of two factors. First, prices rose by about 20 per cent during the Second Plan period. Second, there was no cushion of foreign exchange reserves that could be drawn upon to offset the adverse effects of deficit financing. Hence the limit of defict financing in the Third Plan was kept at the minimum warranted by the genuine monetary needs of the economy.

There is, however, no precise way of estimating the limits of safe deficit financing. Increase in money supply takes places not only through the budgetary operations of Government but also through credit creation by the banking system. Both these have to be viewed together and their appropriate limits decided upon in the light of relative requirements as well as what the economy can absorb in the aggregate.[25/] Therefore, during the Third Five Year Plan, deficit financing was limited to Rs.550 crores out of a total public expenditure of Rs.7,500 crores. This is exclusive of the direct extension of credit by the Reserve Bank to the cooperative agencies. The amount of deficit financing that can be undertaken has, however, to be judged from year to year in the light of the emerging economic trends. What is required for implementing the Plan, whether in the public or in the private sector, is the real resources and these depend upon the rate at which production goes up and the extent to which the community is prepared to defer consumption and enlarge savings. Deficit financing within moderate limits has a place in development planning, but if it adds to purchasing power unduly at a time when the need is to keep it down so as to restrict consumption within the limits provided for the plan, the consequences to the economy can be highly deleterious.

In the first two years of the Third Plan of India the aggregate deficit financing accounted for Rs.339 crores. The budget estimates for 1963-64 put the figure of deficit financing at Rs.241 crores, while the

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25/ Third Five Year Plan of India; P.99, and 100

according to the revised estimates it accounts for Rs.153 crores. According to the budget estimates for 1964-65, deficit financing is expected to account for Rs.86 crores. For the fifth year of the Plan the scope of budgetary deficits will naturally ~~will~~ have to be judged in the light of emerging circumstances. During this period the general price index has gone up by 10 points and price level is very high.

Conclusion

In the post war period a number of underdeveloped countries financed their economies through deficit budgeting, first, for prosecuting the war and later for reconstruction purposes. This resulted in a good deal of inflationary conditions and monetary instability. The underdeveloped countries cannot rely upon deficit spending as a short road to full employment and ~~to~~ higher output. The prevalence of unemployment and underemployment in an over populated underdeveloped economy is due to the lack of complementary factors of production that can be combined with labour and not because of the lack of monetary demand. "This is a long run problem calling for a long run solution."26/ A solution to short run unemployment is sought through an increase in investment. The underdeveloped countries need invest in a way which may increase the productive and employment offering capacity of the economy over a period of time. This can lead to a solution of the long-run problem of under-employment.

The policy of financing budget deficits in underdeveloped countries by money creation is fraught with danger. Unless the magnitude of such deficits is kept within reasonable limits and is adjusted periodically to the changing economic climate serious pressures may emerge. Foreign exchange resources can only be drawn upon to the extent of past accumulations, which are generally small in the countries of the region. Attempts to preserve foreign exchange, to which state the country is

26/ Fiscal Policy in Underdeveloped Countries with Special Reference to India : R.J.Chelliah; P.33, 1960

soon driven, bottle up inflation within the country giving rise to progressive increases in the cost of living, wages, and the cost of production. The operations of this vicious spiral, although delayed by price controls, can hardly be checked unless domestic production rises even though with a time lag. Otherwise, where national output is not rising or is rising at a slower pace, the increase in the price level may gain momentum as the Government is forced to resort to larger deficits in an attempt to divert itself of the responsibility of raising a constant or increasing magnitude of real resources.

The problem with regard to deficit spending is not whether it is feasible or not, but how far it can be applied as a resource mobiliser in the development programme. Deficit financing disburses money income and if that is converted into real income, there is nothing wrong with it.

Deficit spending to be effective must be channelled through proper planning, so that every unit of deficit induced amount must be transformed into real income, although a temporary inflation may develop due to the time required to turn out goods and services. The planners must see that the temporary inflation aet in would be within the limit of control.

When the economy overspends, the various income receiving organisms must not spend it on the consumption sector. But instead the overspent amount ought to go directly into the investment sector. The deficit spending can be resorted to only to finance investment spending in the productive fields. In other cases, it may mean inflation. In the case of deficit spending, the inflationary magnitude and the time period must be determined so as to avert any reverse repercussions that may result from the deficit programme. Generally, the investment in short run yielding less risky projects may preferably be financed with created money income.

In underdeveloped economies, deficit should be incurred to prevent an actual fall in the effective supply of money in the economic system in the face of the gradual absorption of a part of the total money by the large and shrinking non-monetised sector. Beyond this, larger amounts of deficits would create inflation.

Hence the policy of controlled deficit is essential to keep up the tempo of development in an underdeveloped country; and a policy of development with stability should be followed. In a developing economy prices cannot fall. They are bound to go up. Hence simply to keep the rise in prices in check, the development of the economy should not be slowed down. On the other hand, efforts should be made to remove the bottlenecks in production and to increase the supply of consumer goods. Government should so devise its fiscal, monetary, and economic policies as to boost investment and curb consumption so that lasting benefits may be secured for the community through developmental planning financed through budget deficits. Care should, however, be taken to see that price rise is only moderate to keep up initiative and investment. It should not be permitted to cross the safety limit. Deficit financing can be carried only to that limit and no further.

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C H A P T E R V

CENTRAL BANK VISA VIS ECONOMIC GROWTH

The central banking system is the cardinal problem representing the very nucleus of credit and currency of a country. The functions of central banks are not simple, but vary according to the specific economic characteristics of a nation's economy, to the times, and to the changes in the economic structure. The role of the central banks carrying out their traditional functions, especially the policy objectives in regulating credit and currency, has changed with the times, and further it has varied according to the form of the national economy at each period. Before World War I, the statutes[1/] of the Bank gave a list of the operations in which it could or could not engage. In the statutes of the central banks created after the First World War, the objectives were limited to the regulation of the monetary circulation for securing a stable gold value of the currency.

Under the Gold Standard, the value of currency was linked with the value of gold, and importance was attached to securing institutionally the stability of currency value by making an increase or decrease of bank notes depend on the variations in the gold stock. And this institutional stability of currency value was, at the time, considered to mean the stability of economy itself. Hence the role, which the central bank was expected to play, was centred on the achievement of other objectives such as a business cycle policy.

The transition to the managed currency system may be considered to have resulted from the experience of the gold standard system. The managed currency system attempts to liberate the value and volume of currency from the rigid restrictions of gold and to adjust the supply and demand of currency by virtue of a conscious policy.. Thus the monetary

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1/ A survey of Contemporary Banking System Trends, Basu, S.K., Chapter XII, (1957)

policies of the central bank have come to embrace various factors of business cycle policy, and the functions of the central bank have become far less simple than in the days of gold standard.

In consequence, the problem of the purpose of the central bank under the managed currency system has become very crucial. One view is that the managed currency system is a formula not only for securing the stability of currency value through the conscious adjustment of the volume of currency mainly through the central bank but also for promoting thereby the stability and growth of the economy.

This, however, is not to say that the importance of maintaining the stability of currency value as the major policy objective of the central bank has been reduced. On the contrary, it may be said that it has become even more important under the managed currency system to pay closer attention to the stability of currency value. Strictly speaking, however, the stability of currency value is not directly linked with the stability and expansion of the economy. Thus a new problem arises, namely, whether the policy objectives of a central bank should also include considerations for the stability and expansion of the national economy. However, the objective of a central bank consists in the 'supplying of sound currency' defined as the supplying of currency necessary for the stability and expansion of the economy while maintaining the stability of the currency value. The stability of currency value and the sound development of the economy,or in general, the stability and the expansion of the national economy, are objectives which must be attained ultimately side by side.

According to one school of thought the stability of currency value ~~x~~ only should be considered as the purpose of the central bank and that the Bank should devote itself to this objective, inasmuch as economic development tends to be emphasized in actual policy to the neglect of the stability of currency value. The maintenance of a sound

credit and currency system and the stability of the currency value are the basic and essential conditions for the maintenance of an orderly exchange economy and for the promotion of economic stability and expansion.

Indeed, these points cannot be neglected. However, the maintenance of currency value cannot be assured by the policies of central bank alone, and in the second place, the stability of currency value does not necessarily mean the stability and expansion of the economy. Regarding these points, it is necessary to consider the relationship between economic policy, especially fiscal policy and monetary policy.

Under the old concept of free economy it was required that the scale of the Government's budget be as small as possible and that the expenditures be balanced with revenue. To-day, however, the view has become prevalent that public finance should be a positive factor for the stabilization and expansion of the economy. In other words, fiscal policy, side by side with the monetary policy of the central bank, contributes and is expected to contribute towards the stabilization and expansion of the national economy, which is the objective of economic policy. Monetary policy, through adjustments of the supply and demand of currency or through regulation of credit and currency, and fiscal policy, through choice of the scale of Government expenditures, the kinds and rates of taxes and the amount of surplus and deficit, are calculated to promote the stabilization and expansion of the national economy.

Fiscal policy and monetary policy supplement each other, and the choice of what relative importance should be placed on them depends on the conditions prevailing at the time. Generally speaking, monetary policy is effective in curbing business boom excesses, while fiscal policy is more suited for combating depression. Further, the two policies having their respective fields of action, any proper choice

between the two should take into account the nature of the field in which the policy will be utilized.

At any rate, as long as the two policies are destined to pursue ultimately the common goal of contributing to the stability and expansion of the national economy, monetary policy is called upon to maintain an ultimate unity with the Government's economic policy, particularly with its fiscal policy. The stability and expansion of the national economy depend heavily on the integrated operation of these two policies and the close cooperation between the Government and the central bank is important in this sense.

What can be regarded first as an objective of the central bank's operation is the stabilization of currency value. The central bank's monetary policy is aimed ultimately to serve towards the stability and development of the national economy, and this can be achieved through the operation of the central bank's policy in a manner assuring the maintenance of currency value. Recently, the scope of central banking objectives has been considerably broadened. The MacMillan Committee, the Radcliffe Committee and the Keynesian view are further important landmarks in the evolution of central banking.[2/] The preservation of convertibility of monetary unit into gold, stability of exchange and stability of purchasing power were the main objectives of central banking policy before 1930. The Radcliffe Committee laid emphasis on employment, internal purchasing power and steady economic growth as also on strengthening international reserves to finance imports.

The stabilisation of currency value is considered as the most important objective of the operation of the central bank. The aim of the monetary policy of the central bank ultimately is to ensure the stability and development of the national economy. Economic growth

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2/ Sharma, K.K., The Role of Monetary Policy in Planned Economy in India (1963) in press. Also see Sir Oliver Franks, 'Some Reflections on Monetary Policy', P.7 (1960).

can be attained automatically if stabilization of currency value is pursued as a target and full employment too is an objective that should be pursued on the premise of stability of currency value. The importance of the stability of currency value stems from the fact that it is generally understood that a commodity may be purchased at about the same price as previously. This confidence in stability is the foundation of the monetary exchange economy. An impairment of the stability of the currency value betrays this confidence, which leads to a collapse of the economic mechanism. This is, however, subject to two reservations. Firstly, the stability of the currency value cannot be attained through monetary policy alone and secondly, it will not necessarily lead to stability of the economy in general. The fiscal and monetary policy should be in equilibrium. In other words, the Central Bank Statutes in underdeveloped countries should lay an adequate importance on promotional activities, namely, promotion of banking, the setting up of institutions to provide term credit for agriculture and industry, to create a stable security market and the like. The following pages indicate the role of central banking in underdeveloped economies in recent years, particularly since the 1950's.

Economic Growth as an objective of Monetary Policy

'The broad objective of monetary management is to assure the distribution of the monetary flow or income in such a way as to place in the hands of the consumers sufficient means to purchase the output of consumer industries and in the hands of investors funds adequate to maintain the existing production and expand it sufficiently to meet the consumption requirements of a growing population with a rising standard of living.'[3]

The credit control machinery has three main objectives : First, to restrain dangerous business expansion, second, to prevent banking panic

3/ Goldenweiser, E.A., Monetary Management : P.5

in case acute financial tension should develop, and finally, to stimulate recovery in the event of a substantial business recession.[4]

The effectiveness of the monetary policy is conditioned to a large extent by the pace and pattern of economic growth of a country.[5] It also depends on the origin and channels of stimulants for growth and the role of Government undertaking investment and regulating it in the private sector. Proper monetary management can bring about economic stability by exploring the possibilities of increasing production without affecting the level of consumption of the community by controlling the supply of money. In an underdeveloped economy, additional money is required to develop the country's productive resources. The monetary authority through its monetary policy creates additional purchasing power. As Bach has said, " monetary management is supposed to regulate the availability, cost and use of money, both in aggregates and segments so as to make the maximum contribution to a high level of economic stability."[6] But, exclusive reliance upon monetary policy as the means to cope with inflation is a dangerously one sided weapon. Thus, monetary policy alone cannot meet the aims of maintaining economic stability and full employment of resources, but in conjunction with fiscal and other policies, monetary policy can play a significant role in taking the economy to more stable level. Monetary authority cannot enforce investment, but it can, to a certain degree, control the money rate of interest. The goal should be sought through coordination of monetary and fiscal policy. "Monetary management cannot in itself prevent disequilibrium from developing individual branches of production, which may eventually affect the general trend. The importance of such

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4/ Moulton, H.G., Controlling Factors in Economic Development, P.304.

5/ The statutory duty of the Central Bank of Ceylon is to maintain internal monetary stability. See I.B.R.D. : The Economic Development of Ceylon; P.122 (1952).

6/ Federal Reserve Policy Making : G.L.Bach : 33

disequilibrium cannot, however, be underestimated. All these problems are on the borderline between monetary management and general economic planning."[7]

In a developing economy, price inflation has to be kept under check. Government expenditure should be held down to what is urgently necessary and less reliance should be placed on deficit budgets. The tax system should be properly designed to mop us unproductive investment and to divert that into productive channels. We should use the cash surplus to retire Government securities held by the Central Bank and commercial banks, thereby reducing the volume of resources and deposits. Wage inflation caused by increase in wages in excess of productivity should be resisted. Efforts should be made to restrict consumer credit. Savings bond campaign should be intensified. The development of the security market should be encouraged, while speculation based on unsound principles should be checked, and finally, all these measures should be accompanied by methods, such as, limited allocation, rationing and price controls in special areas.

The monetary and banking systems must be made highly flexible, otherwise as Hanson has said, " it would be an easy matter to stop a man from becoming excessively corpulent simply by strangling him to death. A sufficient sharp curtuilment of the money supply could indeed quickly end an inflation. No one denies that, but a programme to stop an inflationary development merely by reducing the quantity of money is a dangerous device. Moderately used, it courts the failure of ineffectiveness; pushed to the needed fanatical extremes, it courts disaster."[8] However, some monetary restraint is necessary and desirable. A judicious use of monetary policy and a firm use of fiscal policy, minimum direct controls including allocation of scarce materials for

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7/ Monetary Reform in Theory and Practice; (1936); Paul Einzig:P.126
8/ Monetary Theory and Fiscal Policy; A.H.Hanson : P.163

essential uses etc., are needed.

Monetary management is the function of Central Banking. It is through monetary management that the Central Bank makes the process of economic development possible and smooth. The various credit control instruments are the weapons in the amoury of the Central Bank, through which it exercises its influence over the money market and controls credit. The Central Bank in a growing economy not only acts as the credit restriction machinery, but it has to see that genuine credit requirements are properly met. Its main function is to direct the expansion of credit and money supply in such a way as to ensure the fulfilment of the leginate requirements of industry and trade and prevent the use of credit for unproductive and speculative purposes. That is why in recent years the Reserve Bank's monetary policy has been one of controlled expansion - a policy of general restraint alongside action to augment the flow of credit into specific sectors, in particular agriculture.[9]

The economic growth of a country also depends on the working and organisation of the capital market. It is through this that investment funds are channellised into useful avenues of production. According to Lavington, "it is the business of the capital market to facilitate the movement of the stream of command over capital to the points of highest yield - by so doing, it enables control over resources to pass into the hands of those who can employ them most effectively, thereby, increasing productive capacity and swelling the national dividend.[10] A well developed capital market makes the monetary system very flexible and sensitive so as to bring it within the orbit of monetary control. "The better developed the market, the more effective will be the normal machinery of Central Banking."[11] Thus the proper

9/ Report on Currency and Finance, Reserve Bank of India, 1959-60, P. 33

10/ Quoted from "Problems of Monetary Policy in Underdeveloped Country"; D.R.Khatkhate; P. 32

11/ Central Banking in the British Dominions : A.F.W.Plumpter, P.4

working of a monetary policy in an underdeveloped country depends on a well-developed capital market. The success of the policy of the Central Bank to promote investment depends largely on the organisation of capital market.

In underdeveloped economies, the total volume of savings is small and consequently the domestic capital formation in such countries is almost negligible. In most of the underdeveloped countries of Asia, due to low level of national income and high propensity to consume, a large number of low income earners have hardly the capacity to save. The capital formation consequently is low and the rates of interests are high. " In some countries, which are in the vanguard of economic progress, net domestic capital formation is 10 per cent of their total national income or more, while in underdeveloped countries, net capital formation internally forms not more than 3 per cent of their total national income.[12]" Even these savings of the community in an underdeveloped economy are not adequately available for investment in fixed capital owing to extravagant consumption expenditure by some of the large income earners, the high liquidity premium attached to gold and the desire to invest in land. Thus the scope of monetary management to direct the resources for investment in productive purposes by the central bank is largely limited because of inadequate growth of banking and other financial institutions and because of the predominance of the non-monetised sector in the national economy.

In India for instance, in 1930, the Central Banking Enquiry Committee[13] hazarded the estimate that the unorganised sector of the money market financed about 90 per cent of the total internal trade of the country. Since then, commercial and cooperative banks have grown steadily and to-day about 50 per cent of the financing of industry and

12/ U.N., Measures for Economic Development of Underdeveloped Countries; P.35

13/ Reserve Bank of India Bulletin : August 1960, P.1105

trade is done by the organised sector of the money market. Further, there is a sub-area of contact between the unorganised and organised sectors with the result that the scope of monetary management is expanding and is at present by no means insignificant.

The method of financing investment through credit and monetary expansion is severely limited, because of its inflationary potential, even though it may form a significantly larger percentage of the total investment expenditure. Owing to increasing state participation in economic affairs, taxation and borrowing are called upon to play an equally important role in meeting the shortage of finance. The whole productive structure in a backward economy being more rigid, the rate of growth of real output is likely to be less than that of monetary expansion with a serious threat to the stability of the economic system. The Central Bank helps economic growth in several ways. First, it helps in organising the money market by developing the banking institutions. Second, it brings about an ~~x~~ integration between the various banking and credit institutions. Third, it helps in the setting up of institutions, which go to make up the capital market where commercial securities like equities and debentures can be created and sold to the public. Again, it regulates the monetary and credit policy in such wise as to secure monetary stability, which is conducive to the raising of domestic and foreign resources for financing economic growth. Further, it controls credit and distributes it in the various sectors of the economy so that comparative stability of price level is maintained and exports are promoted to earn foreign exchange. However, it also prevents resources from going into the speculative channels. The Central Bank also advises Government from time to time on the pursuit of a systematic fiscal and financial policy, which may be helpful in raising the necessary internal and external resources for economic growth. It is not, of course,

incumbent upon the Government to accept the advice of the Central Bank, but usually there is cooperation between the two, so that the fiscal policy of the state may go hand in hand with the monetary policy of the Central Bank.

Central Bank and Industrial Finance

INDIA : The expanding role of the Reserve Bank in the field of industrial finance is a feature of the Indian Central Banking system. The need for speedy industrialisation on the one hand and the lack of adequate facilities in the domestic capital market on the other clearly pointed to the need for adapting and enlarging the institutional structure so as to meet the medium and long term credit requirements of the industrial sector. Recently, a number of institutions have been set up with the help of and under the guidance of the Reserve Bank of India for underwriting commercial securities and for making long term loans to industries. The Reserve Bank of India is a shareholder in many of these institutions and renders them, especially the State Financial Corporations, much assistance in their organisation and working.

The Reserve Bank has contributed to the paid up capital of the Industrial Finance Corporation of India and of the State Financial Corporations. It has subscribed in part to their bond issues also. It also grants loans to them and to the Refinance Corporation and the Industrial Credit and Investment Corporation of India. It gives short-term and medium-term credit facilities to these institutions.[14]

CHINA MAINLAND : The People's Bank of China grants short term loans for the working capital to the public and the cooperative undertakings and to the private firms. It issues state bonds and promotes savings campaign. The Bank grants credit advances to enterprises and institutions according to their Plan allotments irrespective of their assets. The Bank also keeps a watch on the progress of the Plan and the

14/ See Reserve Bank of India Bulletin.

objectives realised. Loans are given for fixed periods and the period varies according to the Plan needs. Credits are granted for working capital i.e., for buying raw materials and the payment of wages etc. The period of loans varies as a rule from three to six months and cannot exceed a year. " Credit is given directly and the staff of the Bank is required to deal with the issues on the basis of personal knowledge and contact. 15/

BURMA : The Union Bank of Burma undertook most of the preparatory work in the setting up of a state Commercial Bank in the country. Within four years of its inception, the Bank had opened eleven branches and its deposits rose from Kyat 11 million to Kyat 360 million. The State Commercial Bank makes working capital available to local industries. Since 1952, the Union Bank of Burma has been granting long term loans for economic development by purchasing debentures, which are guaranteed by the Government. " But in comparison with a number of other underdeveloped countries these loans have not been excessive. The total amount of debentures held by the Union Bank of Burma stood at over Kyat 340 million or 25 per cent of its total assets as on June 30, 1958..... It is the policy of the Bank to encourage their negotiability and create a market for these Government guaranteed securities. 16/

CEYLON & MALAYA : The Central Bank of Ceylon established the Development Finance Corporation of Ceylon, which provides finance to new private industrial projects. By the beginning of 1959, its volume of lending and investment stood at about Rs.10 million. It also contributes to economic development in the public sector by its financing of Government capital expenditure. 17/ The Central Bank of Malaya has the power to purchase, sell, discount and rediscount inland bills of exchange and

15/ New Economy of China; Dr. Gyan Chand; P.303
16/ Central Banking in South and East Asia; S.G.Davies;PP.3 and 7
17/ Central Bank of Ceylon Bulletin (1958)

promissory notes, arising out of bona fide commercial transactions maturing within three months.

PAKISTAN : A recent amendment to the State Bank of Pakistan Act 1956, has authorised the Bank to purchase, hold and sell share and debentures of any banking company established to promote the economic development of any specified area, or of any corporation established for the purpose of promoting agricultural or industrial development in the country. Besides, the State Bank sponsored a scheme for the creation of the Pakistan Industrial Credit and Investment Corporation which came into existence in 1957. By March 1959, within the short period of less than one and a half years, the Corporation had sanctioned loans of a total amount of Rs.48.2 million, of which Rs.33.8 million or roughly 70 per cent were in foreign exchange.

PHILIPPINES : The Central Bank of Philippines also enforced a scheme of priority listing for credit in 1957 for directing resources for investment to promote economic development. As a matter of fact, it was a method of exercising control over credit going to less productive uses. In one year of the enforcement of the scheme the loans granted to industry rose by 73 per cent.[18/]

VIET-NAM : The National Bank of Viet-Nam - The Central Bank of the country, to promote a balanced growth of the monetary and banking sector of the community, entered the field of commercial banking through its association with the Commercial Credit Bank of Viet-Nam. Since July 30, 1958, the above bank has been empowered to deal in long term and medium term transactions only.[19/]

Central Bank and Agricultural Finance

The working and the role of the Reserve Bank of India in the sphere of rural finance has been very striking. The responsibility

18/Central Bank of Philippines Bulletin (1958)
19/Central Banking in South and East Asia; S.G.Davies; P.187

of the Central Bank in this field has been occasioned by the predominently agricultural basis of the Asian countries and the urgent need to expand and coordinate the credit facilities available to the agricultural sector. To fulfil this objective, under section 54 of the Reserve Bank of India Act a special Agricultural Credit Department has been set up, whose functions are :

(a) To maintain an expert staff to study all questions of agricultural credit and be available for consultations by the Central Government, State Governments, State Cooperative Banks and other banking organisations.

(b) To coordinate the operations of the Bank in connection with agricultural credit and its relations with state cooperative banks, and any other bank or organisations engaged in the business of agricultural credit.

Institutional credit has been provided for agriculture through the setting up of the state Bank of India on July 1, 1955 and also by empowering the Bank to provide short term, medium term and long term credit to agriculture upto 15 months and also medium term credit upto five years. The Bank extends short and medium term loans to state cooperative banks at a concessional rate, which is 2 per cent below the Bank Rate, i.e., the rate now being charged to the state cooperative banks is 2½ per cent, following the raising of the Bank Rate in 1961 to 4½ per cent. This rate is applicable only in case the finance is used for seasonal agricultural operations or marketing of crops in respect of short term loans and for agricultural purposes in the case of medium term advances.

As the plans have progressed, the volume of short term finance provided by the Reserve Bank of India to state cooperative banks for financing seasonal agricultural operations and marketing of crops at the concessional rate has shown a rapid rise. The State Cooperative Banks were sanctioned credit limits aggregating to Rs.120 crores during 1962-63

as compared to Rs.70.85 crores sanctioned in 1958-59.[20/]

To increase agricultural production, the Bank has started providing medium-term finance for land reclamation and purchase of live stock, etc., upto 5 years at a concession of 2 per cent. The guarantees of the respective state Governments and the promissory notes executed by the borrowing central cooperative banks or societies are the securities for the advances. The Bank grants loans for 3 years, but an amount upto 25 per cent of the loan is given for 5 years. Limits sanctioned to the state cooperative Banks under Section 17(4A) accounted for Rs. 3.58 ~~xx~~ crores in 1962-63 as compared to Rs.7.21 crores in 1961-62. In 1963-64 the corresponding figure was Rs.4.48 crores. The outstanding amount in 1961-62 was Rs.10.92 crores as compared to Rs.9.35 crores in 1962-63. In 1963-64, the corresponding figure was Rs.8.73 crores.[21/]

Under Section 46A of the Reserve Bank of India amendment Act 1955, the National Agricultural Credit (Long term operations) Fund was set up in February 1956, to make long term loans and advances to state Governments for a maximum period of 20 years to enable them to subscribe directly or indirectly to the share capital of the credit institutions, to provide medium term loans between 15 months and 5 years to state cooperative banks for agricultural purposes, thirdly, to give long term loans and advances to central land mortgage banks upto a maximum period of 20 years, and finally, to enable the Reserve Bank to debentures of Central land mortgage banks.

Under Section 46B, the National Agricultural Credit (stabilisation) Fund was set up in June 1956. The fund has been set up to give exclusively medium term loans and advances to state cooperative banks to enable them to convert their short term credit into medium term credit " whenever such conversion becomes necessary

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20/ Reserve Bank of India Bulletin; April,1964.
21/ Reserve Bank of India Bulletin, April,1964, table no.12,P.517

as a result of draught, famine or other natural calamities.[22] This Fund has to be credited with such sums as the Bank may contribute every year, subject to a minimum of rupees one crore. The amount of the Fund stood at Rs.4, crores on June 30,1959.[23]

For providing long term finance for agriculture, the Reserve Bank in 1948 started contributing upto 10 per cent of the debentures floated by central land mortgage banks provided they were guaranteed by the state Governments concerned in respect of repayment of principal and payment of interest. The Bank's share of contribution to such debentures was raised to 20 per cent in 1950. In the year 1953, the Bank agreed upon a scheme of joint contribution to the debentures of the land mortgage banks upto 40 per cent of the issue or the short fall in public subscription, whichever was less. The scheme of joint purchase was given up in April 1956 as no provision was made for long term agricultural credit in the Second Five Year Plan by the Government of India.

The major institutional developments in the field of cooperative credit is the establishment of the National Cooperative Development Corporation, and the passing of the Agricultural Refinance Corporation Act for setting up a Corporation for financing the agricultural development of the country. The former started functioning from March 1963 in place of the National Cooperative Development and Warehousing Board and is expected to impart the necessary drive at official and non-official levels for the execution of cooperative policies. The Agricultural Refinance Corporation is intended to have an analogous position in the field of long-term agricultural finance, as the Reserve Bank now has in the field of short-term and medium-term

22/ Functions and Working of the Reserve Bank of India, 1958,P.84
23/ Report on Currency and Finance-Reserve Bank of India; 1959-60; P.40

finance for this purpose. The main channel of routing the financial resources of the Corporation is intended to be the existing banks, cooperative and others.[24]

People's Bank of China is playing an important part in providing credit to the producers, the trading, the handicrafts and the credit cooperatives in the rural areas. The Bank made special efforts to assist the peasants by lending freely for current and long term needs. * From 1949 to 1954, about 4,100 million yens (Rs.833 crores) were made available for the development of agriculture. In 1953, its rural credit loans accounted for about 870 million yens. The loans were granted for minor irrigation projects, purchase of pumps, fertilisers and agricultural improvements etc.[25] The rate of interest on long term loans was lower than on the short-term loans. They were repayable in easy instalments, the dues were reduced in calamities and the assets of the borrower had no bearing upon his eligibility on the amount of loan granted to him. Agricultural cooperatives were given preference in the matter of loans. No security was asked for and given before the loans were granted. The bank's contacted the peasants through experts, needs were assessed and finances were made available according to needs. Since 1955, the function of providing agricultural finance has been taken over by the new institution - the Agricultural Bank.[26]

The Central Bank of Philippines formulated a scheme for the establishment of rural credit banks and in early 1952 a law was passed for it. The proposed banks are expected to provide credit facilities to agriculture, and within certain limits to rural enterprises or industries other than agriculture. The monetary Board of the Central Bank of Philippines has the power to authorise and

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24/ See The Reserve Bank of India Bulletin, February 1963, PP.184,186 and July 1963, PP.918 - 921 and also the Report on Currency and Finance for the year 1962-63, P.48

25/ New Economy of China : Dr. Gyan Chand : P.310

26/ Ibid : P.311

assist in the establishment of banks in places and localities, which offer no adequate credit facilities to small farmers and to superwise their operations.[27] It also provides technical assistance to banks free of cost. The free technical assistance and other privileges are a type of subsidy intended to encourage the establishment of these banks under the profit incentive and to ensure that the small agriculturists get the credit facilities required by them on reasonable terms.[28] The central Bank is also giving accommodation to the agricultural credit and cooperatives financing administration, to the amount, approximately Pesos 160 million upto the end of March 1959.[29]

The Central Bank of Malaya has the power to purchase, sell, discount and rediscount inland bills for the financing of agricultural operations or the marketing of crops maturing within six months, treasury bills maturing within three months and Government securities of not more than 20 years maturity, which have been publicly offered for sale.[30]

To promote agricultural development, the state Bank of Pakistan maintains a full-fledged Agricultural Credit Department to study problems of rural finance and to coordinate its activities in relation to institutions engaged in the business of agricultural credit. Under the State Bank of Pakistan Order, 1948, the Bank could advance money to finance seasonal agricultural operations or marketing of crops for a maximum period of nine months only. In 1955, this duration was extended to fifteen months. At the same time, the Bank was empowered to discount bills drawn for purposes of financing schemes of agricultural and industrial development of maturity upto five years. The Bank can also participate in the share capital of institutions established for the purpose of promoting agricultural development in the

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27/ Mobilisation of Domestic Capital, U.N.,1953, P.28
28/ Ibid : P.29
29/ Central Banking in South and East Asia, S.G.Davies, 1960, P.179
30/ Ibid : P.116

country, and to lend to them on such terms and conditions as may be determined by the Central Board of Directors. Loans for agricultural purposes have often been provided by the State Bank at concessional rates of interest. To enlarge agricultural credit, the State Bank of Pakistan Act, 1956 provides for scheduling the cooperative banks. 'Whereas, no commercial bank can be scheduled unless it maintains a minimum paid-up capital and reserves of Rs. 5 lakhs, the State Bank has been authorised to relax this requirement in the case of cooperative banks.[31]

During the last decade cooperative credit has made a remarkable advance in the sphere of rural banking in India. In their size, as well as their variety, operations of cooperative banks are now comparable to those of other banks, and as in other spheres of our national economy, so also in that of banking, a flourishing cooperative sector has come to occupy an important place.

Reserve Bank's interest in agricultural credit is sustained mainly by two convictions : Firstly, that the progress of banking in a vast and predominantly agricultural country like ours would not be complete without the growth of a sound system of banking catering to the requirements of the rural areas; and secondly, that the form of association which holds the best promise of success for meeting the genuine needs of agriculturists in the countryside is the cooperative one. The Reserve Bank must direct its support towards making the cooperative agencies themselves stronger and more and more self reliant. The cooperative banks must equip themselves for the ever expanding responsibilities which would devolve on them by building their own resources of capital and reserves as also by attracting more deposits from members as well as from other sources. The State Governments should continue to play an important role in helping the cooperative institutions in their initial stages of growth by taking increasing

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31/ Ibid : PP.152,163 and ~~16~~ 164

advantage of the facility which is being provided by the Reserve Bank to the cooperative banks. But the principal source of the funds which a banking institution lends to its clients must lie in its own borrowings, especially from depositors. Most of the cooperative banks in India have failed to mobilise the current resources available in rural areas and attract deposits. This can be done by improving the quality of service and the ~~fax~~ terms of remuneration. Ideas about security and goodwill play a no less important part.

In this context, the proposal to insure the deposits in cooperative banks assumes further importance. The State Governments being primarily responsible for registration, supervision and guidance of the cooperative banks, have every incentive, therefore, in their own interest, as well as in that of the cooperative banks and their depositors, to ensure by adequate supervision and direction that the affairs of the cooperative banks are soundly managed. Both proper supervision and adequate insurance, are necessary to ensure the most favourable conditions for maximising the deposit resources of banks.

Further, the continued progress of cooperative banking not only requires the ensuring of the adequacy and soundness of the operations of the cooperative banks, but also the adoption of the positive policies to ensure that they can take their rightful place in the general monetary structure in due course of time. To this end in view, the Reserve Bank being charged with the responsibility of managing the currency and credit system, will have to pay in future more attention to the cooperative banking sector than it has done in the past.

Credit Control Methods

Monetary policy in India, particularly since 1956, has been motivated to produce resources for development, to prevent undue price inflation and to distribute the available resources equitably between the various productive sectors. It has also prevented resources from

percolating to the speculative sectors. It has also been characterised by flexibility so as to avoid undue stresses and strains in the economy. To this end, the various instruments of credit control have been applied by the Reserve Bank of India, singly or in combination with varying degrees of emphasis to suit the financial requirements for promoting growth with stability in the country. To bring out their effects, they are analysed as under.

According to section 49 of the Reserve Bank of India Act, the bank rate is the rate at which the Bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the Act. In India, in the absence of a bill market, the bank rate has been 'the base for the Bank's rates on its advances' made from time to time under the provisions of the Act on Government securities or other eligible paper. The importance of the bank rate rests on its effectiveness as a pace - setter for other market rates of interest, both short term and long term on which the decisions to invest both in fixed assets and inventories are made. Second, it is a warning signal to the banking system in particular and to other financial institutions in general regarding the state of the economy so as to enable the financial institutions to modify their lending policies suitably.

In underdeveloped countries, the Bank rate is of small significance in respect of the movement of foreign short term funds. Again, in respect of its impact on the domestic economy, a large part of fixed investment in the economy is undertaken in the public sector. A rise in the bank rate would undoubtedly raise the cost of borrowing by Government, but the increased cost of borrowing need not necessarily reduce public investment in the economy inasmuch as this is primarily determined by the larger planning strategy implicit in the acceptance of objectives relating to economic growth. Of course, with a different complex of interest rates the pattern of Government investment as

distinct from its total size might be somewhat different. In the private sector also the fixed investment too is not very much influenced directly by changes in the bank rate, though the effect is perhaps more pronounced than in the public sector.

It may, however, be mentioned that bank rate changes are not out of place in a country like India where the effects of deficit financing have been kept under check, inter-alia by changes in bank rate also. From the point of view of monetary control, these conditions are undergoing constant changes for two reasons. First, monetisation is expanding and consequently an extension of the organised money market is taking place in the demand for money and its supply with repercussions on the general structure of interest rates both short term and long term.

Variations in bank rate in Indian conditions exercise repercussions on the gilt edged market. Banks hold short term and medium term securities. Hence the effects of bank rate changes should not be very serious on the institutional investors.

Bank rate changes have been far less frequent in underdeveloped countries. In India, after November 1935, the bank rate was raised from 3 per cent to 3½ per cent in mid-November 1951 for the first time. Again in May 1957, it was raised to 4 per cent. In February 1952, the lending rate under the Bill Market Scheme[32/] was 3 per cent, whereas the

32/ The State Bank of Pakistan also introduced the Bill Market Scheme in August 1952, to encourage commercial banks to induce their clients to convert a part of their cash credits into usance bills. Under the Scheme funds were provided at concessional rates of half per cent below the bank rate and half of the stamp duty was borne by the Bank. In 1952-53, the highest amount of such borrowings stood at Rs.11.43 million, but by 1958-59, it had risen to Rs.190.8 million, constituting nearly 84 per cent of the total outstanding advances made by the State Bank of Pakistan to the scheduled banks for details see "Central Banking in South and East Asia", Edited by S.G.Davies, (1960)

advances rate for trade and commerce was 3½ per cent, while that for agriculture for medium and short dated loans was 2 per cent. This was an important element in the promotional aspect of central banking in our country. In March 1956, the rate under the Bill Market Scheme was raised to 3¼ per cent and to 3½ per cent in November 1956. It again became equal to bank rate. From February 1, 1957, the effective borrowing rate against usance bills for scheduled banks went up to 4 per cent, because the Government raised the stamp duty on usance bills to ½ per cent, which has been called 'a fiscal measure with monetary intent'. With a view to avoiding discrimination against borrowing under the bill market scheme, the Reserve Banks lending rate on advances against Government securities was raised to 4 per cent. Bill borrowing had enjoyed a preferential rate till November 1956. From 16th May, 1957, when bank rate was raised to 4 per cent, it became costlier to borrow under the Bill Scheme, ½ per cent being stamp duty on bills in addition to bank rate. From January 1963, the Bank Rate was raised to 4½ per cent

The following table gives the advances made by the Reserve Bank of India to scheduled banks against Government securities and under the Bill Market Scheme from year to year.

Table No. 49

Advances of the Reserve Bank of India to Scheduled Banks and State Cooperative Banks. 33/

(In Crores of Rupees)

Year	Section 17 '3A'	Section 17(4)(a)	Section 17(4)(c)	Total
1951-52	-	171.02	28.82	199.84
1955-56	-	268.64	227.75	496.39
1956-57	-	456.46	560.64	1,017.10
1957-58	-	317.01	305.24	622.25
1958-59	-	399.82	119.75	519.57
1959-60	-	502.06	85.41	587.47
1960-61	-	817.10	255.29	1,072.39
1961-62	-	358.37	284.79	643.16
1962-63	-	337.85	325.70	663.55
1963-64	18.16	469.23	253.99	741.38

33/ The Reserve Bank of India Bulletin, P.517, Table No.12, April, 1964.

From October 1960, the Reserve Bank of India introduced a system of penalty rates. Changes have been made in it from time to time to suit the economy. The Reserve Bank has also been controlling the lending and borrowing rates of banks.

Resort to this method of credit control has also been made, though less frequently, in Ceylon, Malaya, Singapore, Thailand, Burma, China Taiwan, Pakistan, Philippines and Viet-Nam.[34/]

Open Market Operation

By far the most important means for regulating the volume of credit is direct intervention to increase or decrease the amount of cash in the hands of banks by means of official operations in Government securities. These operations are usually known under the name of open market policy. The expansion or contraction of money and credit and of general economic activity by the Central Bank is done in two ways : First, the Central Bank can buy or sell Government securities in order to bring about the desired change in the volume of credit. Any purchase of Government securities places additional money in the hands of the private sector of the national economy, increases the amount of the banks cash reserves and enables the banks to expand credit to an amount that is a multiple of that increase. Any sale of Government securities by the authorities withdraws money from the private sector of the national economy. It reduces the amount of bank's cash reserves and enforces a contraction of credit amounting to a multiple of amounts involved in the sale. Second, a purchase or sale by the Central Bank

34/ On December 12,1959, the Central Bank of Ceylon raised the bank rate from 2½ per cent to 3, and was restored to 2½ per cent on 24 Dec.1959; The Central Bank of Malaya raised it from 5 to 6 per cent on July 1, 1960; The Union Bank of Burma raised the rate of interest from 2 to 3 per cent in November 1957, while in Pakistan for the first time in January 1959, the bank rate was raised from 3 to 4 per cent. For details read : International Financial News Survey; I.M.F.,Jan.8,1960 Vol.XII,No.26,P.209;July 8,1960,Vol.XII,No.62,P.418;Feb.6,1959,Vol.XI No.30,P.243,Vol.XV,P.122,178,234,275 and 282,1963 and also Vol.XVI, P.12,30,99; 1964. Also read 'Central Banking in South and East Asia; S.G.Davies (1960) and the Central Bank of Ceylon Bulletin and the Central Bank of Philippines Bulletin.

affects, to some extent, the prices of Government securities and, therefore, influences the long term rates of interest. Thus, it forms a very flexible general instrument of credit control. In India, the environment for open market operations has been generally favourable. The Government security market is fairly well developed, although the holding of Government bonds is predominently by institutional investors, commercial banks being the most important. Institutional investors like. Insurance companies, provident funds and banks are statutorily required to hold a minimum percentage of their assets in the form of Government securities. There is more or less continuous net borrowing by Government which was particularly so during the war years as well as in the period beginning with the Five Year Plans. Government bonds to-day constitute about 25 per cent of national income.

The open market operations have been resorted to by the Reserve Bank of India under sub-section (8) and (8A) of section 17 of the Act with a view to meet the seasonal variations in the Reserves of the banking system. The Reserve Bank of India buyes securities during the slack season. In fact, the mitigation of seasonal stringency and of sharp movements of interest rates was an important object of the establishment of the Reserve Bank of India. The Bank's open market operations have had the object of facilitating Government borrowing and of maintaining the stability of Government bond prices, though the Bank has not been aggressive in this behalf. They have not been employed much as an instrument of monetary policy i.e., for influencing the availability and cost of credit.

Prior to changes in mid-November 1951, the banking system could monetise public debt almost at will. In 1951 November, with the raising of the Bank rate, the Reserve Bank of India announced that it would stop purchasing securities for meeting seasonal requirements of banks except in emergency. At the same time, it would continue to make

advances to banks against eligible assets. This policy continued upto October 1956. During this period, the Bank was able to make net sales of Government securities of about 50 crores. In 1956, the Reserve Bank again modified its open market operations policy. From November 1956, the Bank began to offer discriminating support to the gilt edged market to ease the acute stringency in the money market. Apart from outright purchases or sales, the Bank engages extensively in 'switch operations'. It makes a purchase of one loan against sale of another and vice-versa to maintain an orderly pattern of yields and to cater to the varying requirements of investors with respect to maturity distribution policy. This policy of support continued for less than a year, thereafter, the monetary situation eased substantially and the Bank was again in a position to sell securities.

Under the open market operations scheme, the largest net sale was made of about Rs. 90 crores in 1958-59. A good part of the total net sale of Rs.215 crores in the three years 1957-60 was largely accounted for the accrual of P.L.deposits with the State Bank of India and their investment in Government securities.

Between 1946-47 and 1950-51 there were considerable purchases of Government securities by the Bank, the figure of gross purchases reaching Rs.155 crores in 1950-1951. There was a period of net sales from 1952-53 to 1955-56 and again in the period 1957-58 to 1959-60, there were heavy net sales of securities by the Bank. On the whole, in the last fifteen years, the total purchases of the Bank came to 927 crores and the total sales Rs.897 crores, net purchases being Rs.30 crores during the entire period.[35]

In Ceylon, open market operations have been conducted on a small scale and primarily to support the prices of Government

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35/ Reserve Bank of India Bulletin; June 1960

securities. The obstacles to adopt a strong open market operations policy are : First, the security market is narrow and operations large enough to make any impact on the banks would be likely to upset the market. Second, there is no fixed ratio between cash reserves and credit operations in the commercial banking system of Ceylon. The commercial banks also do not work on a constant liquidity ratio; and they do not increase their loans merely because they are ample. This is true for most of the South East Asian countries. Therefore, open market operations in the absence of a strong security market can hardly be an effective instrument of credit control.

In 1950-51, the State Bank of Pakistan followed a " judicious open market operation policy." The Bank purchased Government securities in 1950 from the banks which needed additional funds to finance the country's export trade during the Korean War boom period. Thereafter, substantial amounts of securities were sold in the market during 1957 and 1958 as an anti-inflationary measure. In Philippines the open market operations have hardly been used because of the absence of bond market.[36/]

Variable Cash Reserve Ratio

Under Section 42(1) of the Reserve Bank of India Act, scheduled banks were required to maintain with the Reserve Bank a minimum cash reserve of 5 per cent of their demand liabilities and 2 per cent of their time liabilities. To enable the Reserve Bank of India to exercise control over credit to a greater extent over the banking system, the Reserve Bank Act was changed in 1956 according to which the scheduled banks were to maintain in reserve with the Reserve Bank 5 to 20 per cent of their demand liabilities and 2 to 8 per cent of their time liabilities in India. The total reserves were

36/ Central Bank in South and East Asia, S.G.Davies; (1960), PP.19,159,161 and 174

not to exceed 20 per cent of demand and 8 per cent of time liabilities. On the excess of 5 per cent of demand and 2 per cent of time liabilities kept with it, the Bank could at its discretion pay interest.

According to an amendment introduced in September 1962, the cash reserve ratio may be varied between 3 per cent and 15 per cent of the total demand and time liabilities in India as against the previous provision of 5 per cent of demand and 2 per cent of time liabilities. Under Section 18 of the Banking Companies Act, 1949, the non-scheduled banks have now to maintain with themselves or in the Reserve Bank cash or balances equal to 3 per cent of their total demand and time liabilities in India.

Recently, the Bank has begun to make use of these provisions and the method was for the first time used in 1959-60. The Bank required the scheduled banks to maintain additional balances equal to 25 per cent of the increase in total liabilities since March 11, 1960. By a notification issued on May 5, 1960, the quantum of additional deposits to be maintained was raised from 25 per cent to 50 per cent, effective May 6, 1960. It was subsequently reduced to 25 per cent. The Bank paid interest on the excess as required under the Act.

The use of the variable reserve ratio provision was necessitated firstly, due to a sharp rise in commodity prices and secondly, this rise took place, unlike in the earlier years, in the wake of an all - round increase in production. Its use, therefore, was based on the recognition of a shift in the character of the prevailing inflationary situation and this sterilised a larger portion of the deposits of the public, which the banks could not use for trade and industry.

Under Section 47 of the Union Burma Act, the banks were required to keep with it 8 per cent of their demand liabilities and 3 per cent of their time liabilities. In 1956-57, there was a sudden spurt in the volume of bank credit, caused in part by speculation in inventories. Therefore, the Bank on August 31, 1957, doubled the minimum reserve requirements to 6 per cent and 16 per cent against time and demand deposits respectively. The additional reserves of 3 per cent against time deposits and 8 per cent against demand deposits were allowed to be kept in any catagory of Government security. In Ceylon, the banks were required to maintain 10 per cent against demand and 5 per cent against savings deposits. In 1951, the Bank raised the reserve ratio against demand deposits to 14 per cent, but again in September 1953 lowered the ratio from 14 per cent back to 10 per cent. However, " the method had little or no effect on the dominant problems of the period, since monetary policy lacked the support of fiscal and other Government policies."[37/]

In China-Taiwan, under Chinese Banking Law the commercial banks are required to maintain a Guarantee Reserve of 10 to 15 per cent against demand deposits and a cash reserve of not less than 15 per cent against demand deposits. In March 1956, the effective reserve requirements were raised from 13 per cent Guarantee Reserve to 28 per cent Guarantee plus cash reserve, largely because the authorities were alarmed by the sudden increase of demand deposits of the commercial banks. Under the ordinance, the Central Bank of Malaya is empowered to prescribe the minimum amount or amounts of liquid assets each bank should hold, expressed as a percentage or percentages of the sight and time liabilities of the Bank, either jointly or separately. Such percentage or percentages may be varied by the Central Bank from time to time. The minimum which the scheduled banks are required to

37/ Ibid : P.5,13 and 20

maintain with the State Bank of Pakistan is 5 per cent and 2 per cent of their demand and time liabilities respectively.[38] This ratio can also be changed. But neither in Pakistan nor in Malaya the resort to this method has been taken.

In February 1959, for the first time the Central Bank of Philippines raised the cash reserve requirements from 18 per cent to 21 per cent of demand deposits in three stages of one percentage point every thirty days. In Viet-Nam since April 1, 1955, the commercial banks have been required to secure their deposit liabilities with reserve held at the National Bank - the Central Bank of Viet-Nam. Originally the requirements were set at a figure representing 10 per cent of total commercial bank deposits, but on September 14, 1956, the ratio was raised to 20 percent. On June 21, 1957, it was lowered to 15 per cent, and since then it has not been changed.[39]

Moral Suasion

The statutory powers of the Reserve Bank enable it to have a check on the banking companies. The Bank advises them in advancing credit etc., and thus ensures the direction of credits into the desired channels, which have been given priorities in the development plans. Thus the objective of the moral suasion is to divert resources into the priority channels as well as to ensure that the resources may not be utilised for speculative purposes. Consultations and agreements for commercial banks for exercising voluntary restraint took place in Ceylon and India.

In September 1949, following the devaluation of the rupee, the Reserve Bank called upon the representatives of the leading bankers to refrain from banking advances for speculative purposes. Similarly,

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38/ Ibid : P.28,132 and 135
39/ Ibid : P.175 and 184

in June 1957, the Governor of the Reserve Bank addressed a letter to the commercial banks asking them to reduce their advances against agricultural commodities without affecting the magnitude of their assistance to industry. In July 1957, he held a conference of the leading bankers at which he exhorted them to reduce the level of advances significantly to Rs. 803 crores from the then level of Rs. 937 crores. Since the bulk of the credit resources is concentrated in about a dozen banks in India, the Banks executives can find it profitable to hold frequent consultations with the banks and thus it is possible to achieve some results through pursuasion.

As in the previous year, moral suasion was actively pursued during the year 1959-60. On June 15, 1959, the Reserve Bank issued a letter to scheduled banks drawing their attention to the record credit expansion of Rs.182 crores in the 1958-59 busy season and impressing on them the imperative need to effect a reduction of atleast Rs. 100 crores in the 1959 slack season. Through another circular issued on December 11, 1959, it requested the banks to take steps to discourage the practice of rediscounting clean hundies drawn by parties affected by the Reserve Bank's directives. Again on May 8, 1960, the Reserve Bank issued another directive, which called for a reduction of Rs.110 crores in credit during the ensuing slack season. Besides, on May 21, 1959, the Bank issued a circular to non-scheduled banks requesting them to adopt a cautious policy in the extension of credit against commodities covered by the banks directives to scheduled banks.

The Union Bank of Burma curbs unhealthy bank business through its power of licensing of commercial banks. The Central Bank of Ceylon in 1950-51 specially requested the Commercial Banks not to attend any non essential and, particularly, speculative credit.[40] It also urged the commercial banks to build up their overseas balances. The

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40/ Ibid : P.10

Central Bank of China-Taiwan on July 1, 1957, restrained banks from granting overdraft facilities to their customers. Moreover, the banks were required to classify their loans according to a schedule, separating credit for agriculture, raw material import, inventories, export, marketing, hire purchase, transportation, building stock, exchange financing and real estate mortgages. This was done with a view to make credit control more selective and to effectively discourage borrowers from making unproductive investments.[41/]

The regular system of bank inspections that the State Bank of Pakistan has built up over the years has contributed to the development of sound banking traditions. The Bank, in June 1952, issued instructions to authorised dealers not to release foreign exchange for imports; save in the case of items specially generally exempted, unless an irrevocable letters of credit account was opened and supported by a marginal deposit of at least 50 per cent for goods under licence and 75 per cent of the goods under the open general licence. The banks were also asked not to make advances against imported goods in excess of 50 per cent of their value, while insecured advances were prohibited. In June 1955, another directive issued by the Bank, prohibited banks making unsecured advances or against the security of shares of a company in anticipation of their allotment (unless borrowers made a cash deposit of 50 per cent or more of the application money) without the special or general sanction of the Bank.[42/]

Fixing of the margin requirements on outstanding letters of credit is the most effective of all Central Bank instruments for curtailing credit and the one actually employed most often in Philippines. The system operates in conjunction with import categories set up by the Central Bank. In 1957, the weapon was used in its extreme form when, by circular 79, of December 9, cash deposits of upto 200 per cent were

41/ Ibid : P.29
42/ Ibid : P.159

required against imports of non-essentials.[43]

In Viet-Nam the banks have to submit their monthly summery statement of accounts to the Central Bank. Further, the Central Bank is able, using the Professional Association of Banks as an intermediary, to impose moral suasion on the banks. In 1957, to make the lending policy of all banks uniform, the Bank recommended through the Professional Association of Banks that they should adopt uniform lending policies and lower their interest rates from June 1, 1958 as sight deposits, one per cent; six month time deposits, two per cent; advances against first class commercial bills, six per cent; other advances 6½ per cent. These recommendations were accepted by the banks.[44]

Selective or Qualitative Credit Regulation

One of the main disadvantage of the general credit control is that it tends to affect indiscriminately all section of the national economy in so far as they depend on credit. If the Central Bank, by reducing the volume of bank cash compels the banks to curtail substantially the total volume of credit, all categories of borrowers are liable to be affected irrespective of whether or not the specific conditions in their particular sphere call for any reduction . If the monetary authorities bring about a general expansion of credit, it is liable to stimulate not only those industries, which are in need of encouragement but also those, which are overtrading and should be discouraged rather than encouraged. To some extent the disadvantages are mitigated by informal official advice given to the banks about their attitude towards particular type of loans what is called as moral suasion.

In totalitarian countries like China the system of rationing and allocations is a more effective way of influencing production and consumption than even the most advanced system of selective credit

43/ Ibid : P.176
44/ Ibid : P.186

control could possibly claim to be. But the democratic countries, like India, have some political difficulties and cannot depend entirely on physical controls. In them the role of selective credit control methods is of more importance and the physical controls can only support them.

A type of credit control which has frequently been resorted to in the planning period in India is the pressure on banks to abstain from granting loans for speculative purposes. But the effectiveness of such selective credit controls depends on well established traditions of cooperation between the commercial banks and the Central Bank and at the presence of a well-established institution for the purpose of enforcing effective credit control.

Sections 21, 35A and 36(1)(a) of the Indian Banking Companies Act provide for qualitative credit control to be exercised by the Bank and lay down the conditions when the Bank should do so. Section 21(1) empowers the Reserve Bank to determine the policy to be followed by banks in general or by a particular bank in relation to advances in public interest. Such banks or a particular bank will have to follow the policy. According to section 21 (2), the Reserve Bank may give directions to a Bank or banks in general as to the purpose for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances and each banking company has to comply with such directions.

Through circular letters issued from time to time the Reserve Bank has been asking banks to be cautious in their lending in general as well as lending against the securities of specified commodities. It is mainly since the middle of 1956 that the Bank has begun to operate systematically the directive powers conferred on it by the Banking Companies Act. Thus in the planning period in India, the year 1956 marks an important stage in the evolution of the monetary

policy. The objective of this control was to restrain expansion of credit to certain sectors of the economy during certain periods without simultaneously affecting an increase in demand for productive credit. The following table gives the trends in bank credit, deposit liabilities of banks and borrowing from the Reserve Bank for the period 1951-52 to 1963-64.

Table No.50

All Scheduled Banks Business in India[45]

(Rupees in Crores)

Year	Deposit liabilities of scheduled banks	Bank advances	Borrowings from Reserve Bank	Percentage Proportion of 2 to 1
	1	2	3	4
1951-52	822.05	580.45	54.13	70.61
1955-56	1043.15	761.25	65.08	72.98
1956-57	1175.30	900.04	103.16	76.58
1957-58	1451.24	962.73	42.00	66.34
1958-59	1635.01	1013.63	61.86	62.00
1959-60	1902.02	1127.88	79.44	59.30
1960-61	1746.06	1319.54	94.53	75.60
1961-62	1921.87	1407.61	53.04	73.20
1962-63	2042.26	1588.01	71.28	77.20
1963-64	2281.19	1814.67	84.16	79.60

A larger proportion of the increase in Scheduled bank credit went to industry. Industrial advances as a proportion of total advances increased to 38.5 per cent at the end of 1956, the proportion at the end of 1955 being 34.3 per cent. The share of commercial advances declined by 2.6 points to 47.5 per cent.

The selective credit control method has implied the issue of directives from time to time, fixing the maximum ceiling of credit against raw materials, food grains and securities whose prices have risen. Modifications have been made both in respect of commodities and the limit of ceiling. This scheme has been worked with a view to securing growth with stability.[46]

45/ Prepared from the Reserve Bank of India Bulletin, April 1964, Table nos. 3 and 4, PP.504, 505.

46/ See Circulars of the Reserve Bank of India issued from time to time.

Selective controls are not designed to correct the general inflationary pressures within the economy nor is their success to be judged precisely by the extent to which the prices of the relevant commodities have fallen; prices are dependent on various factors bearing on the demand and supply position of commodities. The controls, by arresting an undue expansion of credit in the busy season and accelerating its reduction in the slack season, may be expected to exercise, only a limited, perhaps a marginal effect on prices, more particularly when banks have large liquid resources.

More recently, the Central Banks of Ceylon and Philippines were empowered " to fix maximum maturities for bank loans and investments and the nature and the amount of security required for various types of credit operations and to prohibit an increase in such loans and investments or to limit the rate of increase.[47/] The scope for selective credit control has appeared small in Ceylon. The State Bank of Pakistan in June 1957 issued a directive to curb speculative credit, which provided banks to limit their advances against imported manufactured goods, bullion, foodgrains and oil seeds to a maximum of 60 per cent of the value of such goods and to restrict unsecured advances and advances secured by guarantees to a maximum of Rs. 50,000 only to any individual party. Similarly, authorised dealers were instructed not to open letters of credit to cover imports unless 15 per cent of the amount of credit was deposited with them. These restrictions were withdrawn in November 1958.[48/]

In Philippines, the selective credit control is not so much used, though in April, 1957, a list was prepared to govern bank lending.[49/] First priority was given for agricultural and industrial loans, while the second and third priorities were given to loans extended for

47/ Reserve Bank of India and Monetary Management; G.P.Gupta,P.178.
48/ Central Bank in South and East Asia : S.G.Davies (1960),P.162
49/ Ibid : P.176

Public Utilities and real estate respectively. The last priority went to loans to be made for consumption. Another memorandum issued in December 1957, directed banks to reduce real estate and consumption loans and to limit trust receipts to maturities not exceeding 60 days.

<u>Regulation of the Money Supply</u>

The Central Bank which is in charge of issuing notes has to maintain a certain percentage of note cover in the form of gold or eligible foreign exchange. The size of these reserves sets a natural elastic limit to the extent to which it was possible to increase the volume of currency.

In India, originally there was the proportional Reserve System. Later on, it gave place to the minimum reserve method to suit the growing economy of the country. Now the Bank has to maintain a minimum of Rs.200 crores in the form of gold and foreign securities, of which, gold holdings are of the value of Rs. 115 crores. The foreign securities, in emergency, can be utilised.

Money supply is also influenced by international transactions. An increase in imports has an anti-inflationary or deflationary impact, while that in exports has an inflationary impact internally on money supply. The increase in imports during the Second Plan period has had an anti-inflationary impact on the country's economy. The volume of international transactions is thus another determinant of money supply. These transactions depend upon the fiscal policy of the Government as also on the industrial and general economic policy of the country. Their volume affects and is in turn affected by the monetary situation in and outside the country.

Broadly speaking, the pattern of Government's economic policy is a more important and more effective regulator of the general monetary situation than the credit and monetary policies of the Central Bank. Through deficit financing and other devices, Government can

augment its expenditure, which leads to a rise in money supply.

There is no statutory limit on the extension of credit by the Reserve Bank of India to Government. By creating securities Government can raise its expenditure and increase the money supply with the public. The cooperation of the Government is thus indispensable in ensuring successful implementation of the responsibility of the Reserve Bank of India for maintaining monetary stability.

The Reserve Bank of India Act provides that 'the Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest'. The significance of the Preamble of the Reserve Bank of India Act, which empowers the Reserve Bank to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage is to be understood in this context.

Thus many factors besides the Reserve Bank's own policies affect and have affected the money supply and the monetary situation in the country during the recent years.[50/] All these factors have to be taken into

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50/ In Indonesia, in August 1959, Govt. took several measures to combat domestic inflation and for improving the country's exchange position. Firstly, the value of all bank notes of the denominations of Rupiah 500 and Rupiah 1000 were cut by 90 per cent. Again, 90 per cent of all bank deposits in excess of Rupiah 25,000 were ~~farm~~ frozen and it was announced that these frozen deposits would constitute long-term loans to the Government. Further, the Government decided to apply a partial freeze to Government workers' salaries in excess of Rupiah 2,000 a month and the private enterprises were also requested to take similar action.

In the exchange field, the Export Certificate System(The B.E.System) was abolished and the Rupiah was devalued from the effective export certificate rate of Rupiah 37.85 per U.S.dollar which had been in force since April 18,1958 to Rupiah 45 per U.S.dollar.

The upward movement of prices was checked for some time after the monetary purge. But, there was less success in making the public finance measures effective, which were intended to limit the inflationary effects of the Chronic Indonesian Budget deficit. For details see The I.M.F. News Survey, Vol.XII, No.10, P.79, September 4, 1959 and Vol.XIII, No.52, P.498; July 8, 1960.

account by the Central Bank in the interest of monetary stability. During recent years, particularly since the Second Plan period in India, the main aspect of the monetary policy of the Bank has been to keep inflationary forces under check to make the Plan a success and to provide controlled expansion of money and credit so as to divert the limited resources to productive uses and to discourage hoarding and speculation.

There is a close cooperation between the Government departments and the Union Bank of Burma, which is consulted in matters concerning the national and foreign exchange budgets. From time to time the Bank has also expressed its views to the Government at both policy and technical levels through (a) direct representation by means of official memoranda to the cabinet; (b) through its representative on the National Planning Commission; (c) and through its representatives on various technical working committees. The Central Bank of Ceylon during the Korean War boom criticised the Government policy for running a budget deficit in times of export booms. This criticism seems to have been effective as the large budget deficit of Rs. 154 million in 1950 was reduced to Rs. 11 million in 1951.[51/] The Bank is thus legally obliged to give advice to Government on the economic implications of fiscal policy, and the advisory function of the Bank is regarded as particularly useful. But the Bank has to work on the directions of the Government. In 1959 December an open clash over Bank Rate policy took place between Government and the Central Bank.[52/] Thus, in principle, the Central Bank

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51/ Central Banking in South and East Asia, S.W. Davies : P.8 and 10.

52/ Ibid : See Page 16, (Towards the end of the year, the Monetary Board prepared a programme of a number of Monetary measures of a selective nature designed to halt the drain on external assets. However, the highly unstable political situation of the country made effective Government action impossible. When in December 1959, the Monetary Board raised the bank rate, the care taker Government ordered a reversal of this action and the suspension of the other contemplated measures.

could be directed by the Government to pursue a policy which it did not favour. In practice, the Central Bank would normally seek to assist the Government in every possible way, but in the case of conflict it ~~will~~ would have to yield.

In the planning period, in most of the countries physical controls[53] have come to play an important part as a normal device of monetary policy. In particular, physical control of foreign trade to safeguard the balance of payments position has been generally an adopted practice in most of the Asian countries and its use as a means of monetary policy is likely to increase as conditions become more difficult.

Government intervention to determine production may serve non-monetary economic purposes by aiming at raising the standard of living or the taxable capacity of the community or by aiming at increasing the military strength of the nation. But it constitutes a means of monetary policy if " Government intervention to raise the volume of production by non-monetary means aims at keeping down or lowering the price level, or at improving the exchange position by increasing the exportable surplus and by replacing imports by home production. These aims may be pursued through consumption or through direction of man power. Such intervention need not be confined, however, to an effort to raise the total output. It may be influencing the output of some specific categories of goods and diverting manpower from the production of goods, which are not considered essential from the point of view of monetary policy."..... Thus, "controls of productions constitute means of monetary policy only if they aim at influencing the price level or the balance of payments."[54]

53/ Physical controls are the direct Government intervention to determine the volume and nature of production, distribution, consumption and foreign trade. All these controls may be used as very effective means of monetary policy to bring about monetary stability.

54/ How money is managed : Paul Einzig : P.310

Again, physical controls in the service of monetary policy include controls over foreign trade. In the planning period in most of the underdeveloped countries of Asia, the physical controls of imports for monetary purposes include general bans on imports from hard currency countries. They also include the imposition of imports quotas, fixing quantitative limits to certain imports from certain countries. Their essentially monetary character is particularly prominent when import restrictions are adopted in order to safeguard the balance of payments and avoid the necessity for the devaluation of an overvalued ~~xxx~~ currency. The same effect can also be achieved by means of exchange control. In August 1952, the Government of Indonesia introduced a system of 40 per cent advance payments on applications for foreign exchange. This system was designed with a view that importers may no longer apply for foreign exchange. In 1953, the advance payment limit was raised to 75 per cent and the importers were asked to pay the import surcharges at the time of applying for foreign exchange.[55]

Controls should not, however, be used for their own sake. They should be employed only when their use is made necessary by conditions in which their absence would make it difficult or costly to achieve the legitimate ends of monetary policy solely with the aid of financial devices.

In a developing economy, monetary policy has two main functions : First, it has to maintain monetary stability in the country and second, it has to bring about an increase in investment which is important for a well-balanced economic development programme. Underdeveloped countries are deficient in diversified capital markets to which investors can turn for securing adequate finance. Hence they must rely exclusively on bank credit.

Further, in underdeveloped countries loans to finance investments in the private sector, which are conducive to economic growth

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55/ Indonesia's Economic Stabilisation and Development: B. Higgins: P.5

are not easily available : First, banks have strict standards of liquidity and security. They provide working capital for commerce and do not provide long-term capital for industry or agriculture. Second, the principal depositors and shareholders of the banks, who are usually importers, exporters, and merchants might object to providing finance to new industries, except in ventures undertaken by themselves. Hence banks advance short-term self-liquidating loans even under conditions of monetary stability.

Under such circumstances, the Central Bank of a country can contribute to the better utilisation of the country's real resources. It can facilitate the transfer of real resources to the public authorities for utilisation for productive purposes. Second, it can make credit available to private investors. In the early stages of the development processes, Government has to undertake large volumes of investment, which are essential for the economic growth of underdeveloped countries, but are at the same time either unsuitable for, or insufficiently attractive to private investors. These include the social overhead projects and the projects of the public service nature e.g., building of rails, roads, highways and electric power projects.

The mere diversion of resources from private sector to public sector does not exhaust the potentialities of selective credit policies. An appropriate credit policy also requires that credit be made available on liberal terms for desirable forms of private investments and that the use of credit for other purposes be restricted to the extent to accomplish the desired re-allocation of resources within the private sector without unduly raising the price level.

Conclusion

The Central Banks of South East Asia are of recent origin. They have been set up, mostly in the post war period. They are the signs

of an expression of monetary independence by new states anxious to solve the immense problem of poverty in these regions. From their inception they have trying to improve their country's productive capacity and banking structure while endeavouring to secure 'growth with stability'.

Traditionally, it is the principal business of Central Banks to supervise the ordinary commercial banks and to issue currency, so as to support the general economic policy of the Government. Outside India, the Central Banks of the other South East Asian countries are superimposed on a rudimentory banking and credit structure-though, in India too, the ordinary banking and credit system is not comparable in size or strength with that of the more advances countries of the world. Hence of the two forms of money, bank deposits are much less important than currency in these countries.

There are, however, three functions besides the traditional functions like issuing currency, managing Government accounts, acting as banker to the existing banks, holding foreign exchange reserves, supervising exchange control and undertaking research, which can only be properly carried out by a Central Bank, and which have particular relevance for 'growth with stability'. First, a central bank can help to finance Government spending; Second, it can alleviate the effects of foreign trade fluctuations on the level of domestic activity and prices; and finally, it can promote the sound expansion of ordinary banking and credit facilities.

The financing of Government spending through deficit means is designed to make available to the Government, resources which would be otherwise idle. It is justified, if it does not endanger domestic price stability. Otherwise its very convenience may lead to overambitious Government spending and to the neglect of other methods of tapping resources for development.

The Central Bank must, therefore, keep a close check on the monetary implications of deficit financing and of the Government's fiscal operations in general, and it must assist the Government in formulating a fiscal policy consistent with the aim of growth with stability. Without such a sound fiscal policy, the Central Bank in attempting to achieve price stability by its own efforts, may curtail production in the private sector to such an extent that real income is reduced.

It has to pay attention to the promotional aspects by creating machinery for raising capital for industry and agriculture and by facilitating the grant of loans for the same. This is being done in underdeveloped countries so that investment facilities for the private sector may rise and economic planning may be financed without inflationary conditions.

CHAPTER VI

[illegible]

The domestic capital resources of underdeveloped countries need to be supplemented by foreign capital if the vicious circle of poverty is to be broken in a reasonable period of time. Foreign exchange is needed for the import of capital goods and other developmental equipment. As underdeveloped countries usually do not produce elaborate machinery and tools the demand for such imports tends to be large. For instance, "in the Philippines' Five Year Economic Development Programme about one half of the total cost is to be met by foreign exchange."[1/] The total investment cost of the ten year development programme of Ceylon is placed at Rs. 13,601 million (U.S.$ 2,856 million). It is estimated that foreign assistance and foreign borrowing will be forthcoming at the rate of Rs. 150 million per annum to finance the investment cost of the Plan.[2/] In the First Five Year Plan of Pakistan, according to the original estimates, of the total cost of the Plan of Rs. 10,800 million, both in the public and the private sectors, the foreign aid and loans were to account for Rs. 4,250 million or about 39 per cent, while in the Second Plan, the foreign loans and aid accounted for Rs. 8,000 million or 43 per cent of the total Plan expenditure both in the public and the private sectors. In the Third Plan, the foreign exchange component has been reduced to 30 per cent.[3/] In the Second Five Year Plan of India, according to the original estimates, external resources were expected to account for Rs. 800 crores or about 17 per cent of the total public sector investment in the Plan. In the Third Five Year Plan they are expected to account for Rs.2,200 crores or about 30.3 per cent of the

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1/ U.N.Economic Bulletin for Asia and Far East, Vol. VII,No.3, P.54, November, 1956.

2/ I.M.F., Financial News Survey; Vol. XI, No.50, P.397,June 26,1959.

3/ Outline of the Second Five Year Plan of Pakistan, (1960-65) P.19,January,1960,also Reserve Bank ~~E~~ of India Bulletin,April 1964. P.413

total planned public expenditure. In South Viet-Nam, the share of external resources to the public expenditure in 1955, 1956, and 1957 was about 35.5 per cent, 44.8 per cent, and 40 per cent resiectively.[4/] In Nepal, about 72 per cent of the planned public expenditure was financed through external assistance in the First Five Year Plan. In other countries of the region also, foreign assistance plays an important part in financing the development projects.

With mounting imports of equipment for development projects and of consumer goods for an expanding domestic market, the foreign exchange reserves in most of the South East Asian countries declined rapidly in the post war period. The following table shows the trend of foreign exchange holdings in a few Asian countries.

Table No.51

Foreign Exchange Holdings[5/]

(Millions of U.S.Dollars)

Country	1951	1952	1953	1954	1955	1956	1957	1958 March	1958 June	1959-60	1960-61
Burma	159	198	211	123	92	121	93	94	112	-	-
Ceylon	217	163	114	169	204	221	183	185	164	-	-
China-Taiwan	35	34	45	20	46	63	92	92	85	-	-
Indonesia	231	79	67	167	226	209	185	154	138	-	-
Malaya	262	273	270	291	315	324	328	330	320	-	-
Pakistan	612	258	258	290	322	324	242	267	234	-	-
Philippines	240	227	231	198	140	139	65	75	58	-	-
Thailand	245	239	188	160	186	199	217	220	215	-	-
Viet-Nam	-	-	-	-	125	132	138	127	158	-	-
India	1640	1482	1518	1535	1544	1113	625	561	457	411(a)	327(a)

The unfavourable balance of payments position resulted in an inadequacy of foreign exchange resources in the implementation of the development programmes. The following table gives the balance of payments position of South East Asian countries.

4/ 'South Viet-Nam's Internal Problems ' Bernard B.Fall, Journal of Pacific Affairs : Vol.XXXI,No.3, September 1958, P.245.

5/ U.N,Statistical Office, Monthly Bulletin Statistics; December 1958, Vol.XII,No.12,PP.173-177, Table No.53.

(a) Calculated from Reserve Bank of India Bulletin, PP.1860 & 1861, Table No.2A, November 1961. According to the Reserve Bank of India Bulletin,April 1964,Table No.21,India's Foreign Exchange Reserves in 1963-64 stood at Rs.306 ~~xx~~ crores.

Table No.52

Balance of Payments Position of a Few Asian Countries(+)(-) Indicates Surplus or Deficit respectively in Millions of National Currency. 6/

Country	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	Nov. 1962
1. Burma (Kyat)	+29	+26	+19	+18	+20.0	-27	-40	-	-13.0	+2.0	-18
2. Cambodia (Riel)	+19	+37	+18	-22	-58	-19	-68	-29	-74	-98	-
3. Ceylon (Rupee)	-17	- 3	+35	+40	+10	-10	-	-21	-10	+ 2	+68
4. India (Rupee)	-158	-38	-46	-36	-169	-343	-247	-270	-382	-342	-269
5. Indonesia (Rupiah)	-12	+72	+225	+298	+61	+144	+234	+425	+999	-39	-
6. Laos (Kip)	-21	-26	-44	-51	-99	-119	- 82	- 79	-73	-107	-
7. Federation of Malaya (M $)	+40	+12	+25	-69	+42	+31	+19	+ 61	+65	+32	-5
8. Pakistan (Rupee)	-27	+24	- 7	+35	-31	-41	-39	- 13	-103	-95	-165
9. Philippines (Peso)	-12.7	-9.0	-13.0	-24.5	-4.4	-15.2	-5.5	+0.5	-3.6	-9.3	+1.3
10. Singapore (M $)	-36	-31	-28	-41	-41	-51	-50	-39	-50	-54	-
11. Thailand (Baht)	+60	-22	-41	- 3	-53	-75	-148	-119	-67	-14	-298 @
12. Viet-Nam (Piastre)	-588	-726	-782	-567	-503	-607	-516	-436	-451	-537	-635

6/ Prepared from U.N. Economic Bulletin for Asia and Far East, Vol. IX, No. 3, December (1958), P. 75 and Economic Survey of Asia and the Far East; (1962) : Table No. 17, P. 203

@ October, 1962

The above table indicates that Ceylon, India, Pakistan, Philippines, Singapore, Thailand, and Viet-Nam have all shown a considerable deficit in their balance of payments account. Cambodia, which had a surplus of the balance of payments upto 1954, has been consistently running in deficit since then. In India this has been mainly due to a considerable increase in imports. Imports rose from about Rs. 979 crores in 1951-52 to Rs.1121 crores in 1962-63, while exports accounted for Rs. 738 crores in 1951-52 and declined to Rs. 688 crores in 1962-63.[7/] The actual increase in the import quotas in India began from the beginning of the Second Plan. It was because of the fact that heavy machinery was imported to a very great extent to fulfil the aim of setting up of heavy and basic industries in the country. In other countries also, the rise in imports has been the main factor in their unfavourable balance of payments position.

To overcome the shortage of foreign exchange, the Government in most of the countries in recent years have imposed restrictions on imports of luxury commodities and stopped the import of certain commodities altogether, while a few countries had to drop some of the projects, which they previously planned in their development programmes. In Burma, for instance, the Government ' in 1955 cut back departmental spending, and Open General Licensing was temporarily abandoned for most consumer goods.[8/] Similarly in the Second Plan of India and in the First Plan of Pakistan, shortages of foreign exchange hampered the economy at every turn. For lack of foreign exchange, domestic resources could not be fully mobilised for development and tended to be invested in construction and other sectors requiring

7/ See Reserve Bank of India Bulletin; Table No.42; P.554, April,1964.

8/ ' Burma's Decade of Independence'; E.V.Francis; Journal of Political Quarterly; Vol.XXIX,No.3,P.254, July-September, 1958

relatively little foreign exchange. They would not be diverted to more productive channels. These problems of foreign exchange were expected to limit the progress of implementation of the Second Plan of Pakistan also.[9/]

The rate of economic development can lead to significant acceleration, if the flow of capital from developed to underdeveloped countries is maintained. Efforts should, therefore, be made to create conditions which may lead to a greater inflow of foreign capital to the developing countries. Unless there is a substantial supply of foreign capital on favourable terms, the implementation of development programmes will not be possible.

The magnitude of the possible balance of payments difficulty resulting from implementation of a development programme depends to a large extent on the size of the programme, the nature and distribution of import substitutes and export promotion projects in the total programme and the timing and the terms of servicing of foreign loans.

A developing economy can achieve a higher rate of economic growth and need impose less strain on its domestic economy if more external finance is available.[10/] Any further major expansion of our economy, particularly in the industrial field will depend mainly on our ability to ensure a continuous flow of fresh capital. Except for such success as we may achieve in bringing into use some of the accumulated and hidden wealth in our country, the amount of fresh savings from within India will clearly not be adequate to finance development of the magnitude, and at the rate required to provide foreign exchange for imports of new capital equipment.[11/] This is true in the case of other underdeveloped countries also.

9/ Outline of the Second Five Year Plan of Pakistan; Planning Commission Government of Pakistan; P.15, January, 1960.
10/ E.C.A.F.E. Bulletin, Vol.VII, No.3, P.58, November, 1956.
11/ Industrial Development - A Guide to Accelerating Economic Growth, Murray D.Bryce - 1960, PP.67,68.

Aid may be placed in a broad perspective by regarding it as an attempt to make the best use of available goods and services in pursuit of achieving the higher standards of living, but its use should be carefully examined in the light of its effectiveness as compared to other techniques for accomplishing similar objectives. The criteria used to determine the amount of aid to be taken should relate to its need and ability to use the aid effectively as well as the capacity to repay that aid.

The feasibility of external assistance in an underdeveloped country depends on its capacity to augment productivity and the maximum possible benefit which it can yield to the recipient country. It is from this standpoint that one should examine the characteristics of external assistance with regard to its form, continuity and time.

External resources can be made available to a country in the form of technical and financial assistance. The former provides guidance and knowledge in the incorporation, within a development programme, both of relatively scarce domestic resources and of such external resources as can become available. In order to contribute to the fullest extent to a country's productivity, external assistance must possess an element of continuity. Development programming, either on an overall or on a sectoral basis, will prove difficult if external assistance movements are relatively erratic. It is equally necessary that external assistance should flow into the specified segments of the programme at stated times when the development programme has been worked out and when a certain amount of external assistance has been envisaged.

Sources of Supply and Forms of External Resources

There are a number of sources like International agencies,[12/] Governments or private individuals or firms which supply external

12/ These Institutions have been discussed in the next chapter.

assistance to the underdeveloped countries. These institutions provide assistance in the form of : (a) direct foreign investment; (b) equity financing; (c) technical assistance (i) experts sent as advisors, (ii) scholarships granted for higher education, and (iii) engineers and technicians sent for giving training and helping the underdeveloped nations in the selection of projects and implementation of programmes.

Inter Governmental Loans and Economic Aid

The term 'economic aid' includes both grants and long term credits. International grants are additions to resources from the outside world. They do not require repayment and, therefore, impose no annual interest charges on the receiver. Different forms of grants have played a decisive role in the post war period in the recovery of the major parts of the world from war time maladjustments. The programme of the United Nations Relief and Rehabilitation Administration, Rehabilitation aid in parts of the Far East and the assistance of the Economic Cooperation Administration to Western Europe are the outstanding examples.

In the post war period economic aid programmes of U.S. included relief assistance in the form of food, clothing, medicine, etc., wheat loan under P.L.480 to India and Pakistan as outright grants and reconstruction aid for purchasing material and capital equipment in the form of loans. Technical assistance is also being provided by various nations. One of the aims of aid programmes to underdeveloped countries is to create conditions, which would make the extension of further aid unnecessary and to make the economy self-generating. This can be called as the take-off-stage, which the developed nations attained long ago, and the underdeveloped nations are trying to reach now.

The relief grants in the post war period have been extended ~~xxx~~ either from a humanitarian motive or as military aid to fight

communism or capitalism. Of the two types of grants, in the post war period the latter is becoming more important and its magnitude is incalculable.

The multiple objectives of the U.S. military aid given to underdeveloped countries of South East Asia are said to be : Strengthening local defence forces, including both these required for external defence and internal security; providing local military basis, and building military facilities or infrastructures. The latter two objectives were conceived especially in relation to their contribution to the military effectiveness of U.S. forces which might possibly intervene in particular local war contingencies. During the 1948-50 period of intensified cold war in Southern Asia, U.S. economic and military aid became a major instrument of a foreign policy whose immediate aim as expressed in Truman Doctrine early in 1947, was to strengthen the will and capacity of free countries to resist communism.13/-

The advocates of the military aid assistance argue that it provides additional goods permitting domestic resources to be diverted to promote economic growth, but they fail to assess the hardship and strain which other neighbouring countries of the military assistance receiving countries have to face. They also have to divert most of the resources in strengthening their military defence. Some times this military assistance leads to severe civil war and political instability, which may retard economic growth of the nation. Most of the South East Asian countries are facing this difficulty even to-day. Below is given an account of the military assistance given by U.S. to South East Asian countries between 1951 and 1957 under the Mutual Security Programmes.

13/ Foreign Aid : Theory and Practice in Southern Asia (1960), Charles Wolf Jr. , P.407. Under Kennedy Administration, America laid greater emphasis on economic aid to underdeveloped countries.

Table No.53

Funds Obligated for U.S.Military Support in Countries of Southern Asia, Fiscal Year 1954-1957 14/

(Millions of U.S.Dollars)

Country	1954	1955	1956	1957	total
Indochina	678.6	435.8	254.5	272.5	1641.4
Cambodia			32.9	23.6	56.5
Laos			42.1	38.5	79.6
Viet-Nam			179.6	210.5	390.1
Pakistan			40.9	37.0	77.9
Philippines		9.5	2.5	-	12.0
Thailand		8.4	-	-	8.4
TOTAL	678.6	453.7	297.9	309.5	2265.9

For the year 1951 to 1957, the total U.S.economic and technical aid obligations in the countries of Southern Asia under the Mutual Security Programme accounted for $ 1335.7 million in thirteen countries. The countrywise break up is given in the following table.

Table No.54

Funds Obligated for U.S. Economic and Technical Assistance in Countries of Southern Asia - Fiscal Years 1951-1957 15/

(Million of U.S. Dollars)

Country	1951	1952	1953	1954	1955	1956	1957	Total
Burma	10.8	13.7	6.9	0.0	0.0	0.0	25.0	56.4
Ceylon	0.1	0.0	0.0	0.0	0.0.	5.0	6.1	11.1
India	5.2	52.7	43.6	86.9	84.4	60.9	68.7	402.4
Indochina	21.8	24.6	24.0	24.5	26.8	41.5	65.9	229.1
Cambodia	-	-	-	-	-	(12.2)	(10.9)	-
Laos	-	-	-	-	-	(6.6)	(5.9)	-
Viet-Nam	-	-	-	-	-	(22.7)	(48.9)	-
Indonesia	8.0	8.1	3.6	3.9	7.0	11.1	26.7	68.4
Nepal	0.1	0.2	0.5	0.7	2.4	2.0	4.4	10.1
Pakistan	0.5	10.6	26.8	22.7	71.4	66.7	61.7	260.3
Philippines	15.1	32.1	17.9	14.5	19.6	26.6	33.9	159.7
Thailand	8.9	7.1	6.5	8.7	38.2	34.5	34.5	138.3
TOTAL	70.3	149.1	129.7	161.9	149.3	248.2	326.8	1335.7

14/ Ibid . P.404

15/ Foreign Aid Theory and Practice in Southern Asia (1960) Charles Wolf Jr., P.403. The figures in the above table exclude surplus commodity assistance under P.L.480 to Indonesia ($ 98 million in 1956; Burma, $ 17 million in 1957; and India $ 290 million in 1957)

During the years 1951 to 1957, India has received the largest amount of foreign aid in the form of U.S. economic and technical assistance. It accounted for U.S. $ 402.36 million. Pakistan comes next to India and the U.S. economic and technical assistance received by it during the same period accounted for about $ 260.3 million.

The U.S.S.R. is also providing economic, and technical and military assistance to the countries in the communist block as well as to neutrals.[16] The following table gives a comparative account of the Soviet Union loans and the U.S. assistance to the underdeveloped countries.

Table No.55

Economic Aid by the Soviet Block and the U.S. Government to South and East Asian Countries[17]

(Millions of U.S. Dollars)

Recipient Country	Soviet Block Countries 1945 to 1957		U.S. Government Aid Deliveries 1945 to 1957		Total
	Credit agreements signed	Estimated deliveries	Credit	Grants	
India	362	89	225	273	498
Indonesia	113	23	158	128	286
Ceylon	26	6		6	6
Burma	22	7	5	21	26

The Soviet Aid to underdeveloped countries is in the form of loans bearing a low rate of interest. It does not consist of free grants-in-aid. On the contrary, U.S. Government economic aid programmes consist both of free grants in aid and credits. Between 1945 and 1957, of the total U.S. economic aid to India 55 per cent was in the form of grants-in-aid and 45 per cent in the form of credits.

Technical Assistance and Economic Growth

In most of the underdeveloped countries economic progress is checked on account of inadequate technical know-how. These countries

16/ The Economic Development of Communist China; T.J.Hughes and D.E.T.Luard, P.72 (1959). Also see Joseph S.Berliner; Soviet Economic Aid; Table No.5,P.52 and 'The New Economy of China; Dr.Gyan Chand;P.360.

17/ Soviet Economic Aid,Joseph,S.Berliner,Table No.6,P.57

usually lack the internal coordinating machinery necessary to ensure the proper selection of priorities, the best phasing of development projects and the mobilisation of technical assistance to secure the best results. Therefore, a significant contribution can be made by the expansion of international cooperation among countries. The amount of scientific and technical knowledge available for this task is greater now than ever before and it is continually increasing. The immediate problem to-day is to organise and direct the external technical-know-how into channels where it can produce the speediest and most constructive results. The aim of external technical assistance should be to increase productivity of material and human resources in underdeveloped countries so that a wide and equal distribution of the benefits of such increased productivity may help to contribute to the realisation of higher standards of living for the entire population. Together with this "due attention and respect should be paid to the national sovereignty and national legislation of the underdeveloped countries and to the social conditions which directly affect their economic Development.[18/] The objective of technical assistance should be to assist underdeveloped countries to get the best possible advice and technical information to solve their developmental problems.

The patterns of economic development which fit the social and economic structure of the technically more advanced countries cannot be applied without modification to those which have remained underdeveloped. "It is an ~~x~~ illusion that the provision of aid is an automatic self-adjusting process. Ceylon requires an expert on chicken rearing, and Australia is willing to supply one : hay presto;

18/ 'The Technical Assistance Programme of the United Nations's A.D.K.Owen, Journal of Political Quarterly, Vol. XXII,No.4, P.323, October-December, 1951

the problem is solved. But the chicken expert must first turn himself into an expert on conditions in Ceylon before his prior expertise will be of the slightest value. Neglect of this simple precaution has ruined more aid ventures than any other factor.[19]" Therefore, the technical help should be given keeping fully into consideration the needs of the country as well as the natural, social and cultural factors prevailing in the country. If these things are not kept in view, the technical-know-how will go waste without substantially increasing the country's productive capacity. Moreover, if instead of increasing economic productivity, the technical-know-how is being provided to increase military strength, it can lead to frastration and may even prove detrimental to the economic growth of the underdeveloped nations.

Further, in every country development must be brought about mainly through the efforts of the local population, with the help of the domestic resources and by means of appropriate changes in economic and social structure. In some cases external technical assistance may be crucial, but the major part of the labour and capital must come from domestic sources. Too great and too long continued dependence may impede rather than accelerate development along sound lines.

Guiding Principles of Technical Assistance Programme

The main requisites for the successful implementation of the technical assistance programme are : First, it should not be a means of foreign economic and political interference in the internal affairs of the country concerned and should be free from any consideration of political nature. Second, the feasibility of such a programme should be judged by its practical success in adopting and

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19/ 'The Name and Nature of Foreign Aid, Bugh Tinker; Journal of International Affairs, Vol. 35, No. 1, P. 45, January, 1959.

combining scientific findings and technical experience from many sources to meet the requirements and resources of particular countries. The technical assistance must be designed to meet the needs of the country and it should be suitable for use in the particular recipient country. Again, experts provided must be selected not only for their professional competence, but they must also have an understanding of the cultural background and of the basic problems, which face the country in which they are to serve. The technicians should not have pre-planned notions. Technical assistance should be provided by the participating organisations only in agreement with the Government concerned and on the basis of specific requests made by them. It should be rendered only to or through the Government and should be of a high quality and technical competence.

The needs of the underdeveloped countries are many and urgent. The expanded technical assistance programme should essentially be a long-term undertaking as the need for concerted efforts on a substantial scale will continue for many years before they become largely independent of outside technical aid. The technical assistance programme must relate to long-term programmes of economic development.

Forms of Technical Assistance

The form of assistance furnished to an underdeveloped country depends on the particular needs of the country concerned. In most of the countries, due to lack of widespread education, the Government fails to Plan development programmes properly. Thus to assist Governments whose own machinery in this respect may still be rudimentary, the basic form of assistance which the international organisations can provide is in the form of teams of experts sent to perform specific tasks which may vary from simple short range ones to extremely complex and long range ones. Such experts may be responsible

for the operation of specific projects. They may serve as advisors to appropriate branches of administration, or as consultants for training periods on special problems. Advisory missions may sometimes be required also to assist the Government of an underdeveloped country to make a general assessment of its human and material resources and then framing a programme for its economic development.

Complementary to such expert missions is the advanced training of technicians from the underdeveloped countries either at home or abroad. The lack of trained personnel, both in the skilled trades and at advanced technical, professional and managerial levels is one of the major obstacles to the economic development of underdeveloped countries. Therefore, means must be found out to overcome this difficulty.

Technical assistance can also be provided to underdeveloped countries in the form of information on the latest techniques and assistance in discovering the most suitable machinery and equipment. Such type of assistance is required by industrial and agricultural organisations or services and by technical research and teaching institutions, and will enable them to take advantage of the recent developments throughout the world. Here the international organisations can render a great service to the underdeveloped countries, because not only do they have experts on their staff trained in various problems which concern the underdeveloped countries but they have the pledged cooperation of their member Governments and are in contact with Governments and private technical institutions throughout the world.

The nature of the technical assistance that has so far been provided by the World Bank on Government basis ranges over the whole of economic and social development; including nationwide economic surveys, organisation of central and local Government services, or the

construction of roads, railways and electric power plants and the training of teachers and the development of cottage industries.

The rendering of Technical assistance encounters many difficulties. Some of them are inherent in the very conditions of economic underdevelopment which technical assistance is designed to remedy. There is sometimes an imperfect appreciation in the underdeveloped countries of the character of their total needs and a consequent misunderstanding as to the proper priorities to be assigned to projects of economic development. At the same time, the transference of the knowledge, skill, and experience of the developed countries is far from a simple operation and more experience will be needed to ensure the success of every operation under-taken.

The main difficulty which the underdeveloped countries face is in respect of fully mobilising their domestic resources. The President of the I.B.R.D. at the meeting of the Economic and Social Council in February 1951 said, "some countries have sufficient resources and credit to enable them to carry out development on the basis of borrowing from abroad. I think we should frankly face the fact that others do not; they cannot adequately accelerate the rate of their development if the only capital which they receive is in the form of loans which they have a reasonable prospect of repaying."[20/] To augment production, it is therefore, necessary to plan properly and to exploit the human and material resources to the fullest extent. This objective can be achieved if the underdeveloped countries invite foreign experts in place of sending their people abroad to receive training. In the first place, this will help these nations to have on-the-spot planning of the projects; Second, a large number of people

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20/ 'The Technical Assistance Programme of the United Nations,' A.D.K.Owen, Journal of Political Quarterly, Vol. XXII,No.4, P.333, October-December, 1951

can get technical training, and finally, they can save much of our foreign exchange also, which can be utilised elsewhere.

Private Foreign Investment

Private direct or entrepreneur investments and private lending played a predominent role in external financing in the past, particularly upto the outbreak of the first World War. The inter-war period was characterised by considerable private lending and direct investment in the early post war period only. After the nineteen thirty's depression, it failed to be resumed on a significant scale. The recent post-war period, especially 1947-48, has witnessed a substantial revival of private direct investment but not of private lending. Both, however, have been heavily overshadowed by inter-governmental lending and by international loans and grants.

In Asia and the Far East, Philippines appears to be the only underdeveloped country having attracted significant amounts of private investment capital in recent years. The rest depend to a large extent on the inter-Governmental assistance for sustaining their imports......the ten low income countries of Asia, Burma, Ceylon, the Republic of China, Indonesia, India, Iraque, Pakistan, the Philippines, Thailand, and the Republic of Viet-Nam, which received less than $ 100 million of private long-term capital had a net inflow of more than $ 600 million in official long-term capital and grants in 1957.[21/]

Despite the efforts of the Government, India in recent years has not succeeded in attracting much private foreign capital. The overall total of foreign business investment to the end of 1953 has been estimated at Rs.419 crores, (or $ 880 million). Of this total, about 80 per cent represents investments from the U.K. The second largest investing country was the U.S., but its total in 1953 accounted for only Rs. 31 crores. Some investments of smaller dimensions

21/ U.N., The International Flow of Private Capital;1956-58,P.14,1959

have come from the continental Europeon countries. Since 1953, the flow of foreign investment has continued and to-day the grand total should be approximately of the order of Rs.500 crores.[22] Measured against the scale of Indian needs, the flow of foreign private investment has been quite inadequate. One important factor is the changed character of the international capital market. The old long-term private capital markets centred in the Western Europeon capitals and New-York have almost gone. Their work in floating shares and debentures of overseas business enterprise is now unimportant. The same is true of their trade in outstanding securities, while their important role in floating foreign Government bonds has just about ended

Since the end of second world war, the bulk of the private capital exported to the underdeveloped areas, including India has been that involved in the establishment by foreign companies of overseas branches or subsidiaries. This type of direct of controlled capital investment accounts to-day for more than four-fifths of all foreign business investments in India. It means that taxes on branches or subsidiaries of foreign companies operating in India, and individual taxes affecting their local managers and staff, can have a crucial effect on the flow of foreign investment.[23]

Private foreign investment throughout the period since 1945 has fluctuated at a low level and without any sign at all of an upward trend. In low income areas the domestic market is small. Hence direct business investment as a means of financing economic growth was largely concentrated on extractive industries, mines, oil wells, plantations, producing raw materials for export mainly

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22/ Taxation and Foreign Investment, National Council of applied, Economic Research, New Delhi, 1957, P.7

23/ Ibid : P.8

in the advanced countries. This is the colonial pattern of foreign investment, which was common upto the end of the second world war.

The gross inflow of private investments[24/] at Rs.26.1 crores in 1958 showed virtually no change as compared to 1957. The gross inflow was smaller than in 1956 (Rs. 31 crores) but considerably above the average for 1954 and 1955 (Rs.19.9 crores). Since the capital inflow in the three year period 1954 to 1956 contained a larger proportion of retained earnings than in 1957 or in 1958, fresh capital receipts in each of these two years stood higher at about Rs.16 crores as against Rs.11.6 crores in 1956 and an average of Rs.7.9 crores in 1954-55.

Table No.56

Inflow of Foreign Investments into the Private Sector in India[25/]
(Rupees in Crores)

	1954 and 1955 (annual average)	1956	1957 revised	1958 revised	1959
A. Inflow of Private Foreign Capital (net)	14.9	24.9	17.9	2.4	10.8
1. Gross Inflow	19.9	31.2	26.9	26.8	25.6
(i) Retained Earnings	12.0	19.5	9.5	9.8	15.1
(ii) Cash Inflow	1.5	3.1	5.9	4.8	3.3
(iii) Non-cash Inflow	6.4	8.5	11.4	12.3	7.2
2. Outflow	5.0	6.3	9.1	24.4	14.8
B. Official Capital	1.4	12.1	32.1	25.3	27.3
C. Gross Inflow into the Private Sector	21.3	43.3	59.0	52.1	52.9
D. Net Inflow into the Private Sector	16.3	37.0	50.0	27.7	38.1

24/ The capital inflow from private sources from abroad may be expressed on the gross or a net basis. Since most of the private foreign investment which takes place in India is associated with the setting up of new enterprises or expansion of existing enterprises rather than with purchases by foreigners of outstanding shares in the stock market, figures of gross inflow are a good indicator of the contribution of foreign interprise to the building up of capital assets in the country. On the other hand the net concept, by allowing for repatriation of capital, that is for the transference of assets to residents etc., indicates how much foreign capital continues to remain employed in the economy from year to year. Where the intention is to find out whether investment opportunities in a country are widening, it is sufficient to consider the gross figure.

25/ Reserve Bank of India Bulletin, P.675, May, 1961.

The gross capital inflow from private sources amounted to Rs. 25.6 crores in 1959, as against Rs. 26.8 crores in the preceding year. It was also lower than in 1957 and 1956, but sizeably higher than the annual average for 1954 and 1955.

Fresh capital receipts from abroad, as distinguished from retained earnings, for the establishment of new units as well as for expansion of existing undertakings, were lower in 1959 at Rs. 10.5 crores as against Rs. 17.1 crores in 1958. In this connection approvals given for issue of shares to non-residents would appear to be a better guide to the foreign investor's response to the changing investment climate in the country, since there is usually a time lag between the grant of approvals for issue of shares and the actual allotment of these shares. Approvals for allotment of shares to non-residents in 1959 were, in fact, significantly higher at over Rs. 19 crores as against Rs. 13 crores in the preceding year. The rate at which shares were actually allotted was, however, rather slow in 1959, with the result that the allotment of shares amounted to Rs.6.3 crores in that year as against Rs.7.5 crores in 1958. The decline in the rate of actual allotments is reflected in the reduced inflow of fresh capital mentioned earlier.

Another source of foreign private investment is provided by the retained earnings of foreign controlled companies. The amounts retained for some recent years are shown in the following table.

Table No.57

Profits of Foreign Controlled Companies in India 26/

(Rupees in Crores)

	Petroleum	Manufacturing	Plantations	Others	Total
	1	2	3	4	5
1956					
Earned	16.6	12.4	10.7	7.0	46.7
Distributed	6.9	6.8	9.0	4.5	27.2
Retained	9.7	5.6	1.7	2.5	19.5

26/ Ibid : P.676

	1	2	3	4	5
1957					
Earned	12.5	10.7	5.3	6.6	35.1
Distributed	7.1	6.9	6.8	4.8	25.6
Retained	5.4	3.8	-1.5	1.8	9.5
1958					
Earned	11.0	12.9	4.9	6.4	35.2
Distributed	5.4	7.8	6.3	5.9	25.4
Retained	5.6	5.1	-1.4	0.5	9.8
1959					
Earned	10.6	16.1	5.7	6.0	38.4
Distributed	4.5	9.0	4.8	5.0	23.3
Retained	6.1	7.1	0.9	1.0	15.1

Unlike in the preceding two years, in 1959 there was a substantial rise in profits ploughed back in business which rose to Rs. 15.1 crores from Rs.9.8 crores in 1958 and Rs.9.5 crores in 1957. They were, however, lower as compared to the high of Rs.19.5 crores reached in 1956. Total earnings of foreign controlled enterprises accruing to non-residents amounted to Rs.38.4 crores in 1959 as against Rs. 35.2 crores in the preceding year. It is significant that during 1959 the increase in retained earnings exceeded the rise in aggregate earnings, since distributions out of earnings were reduced. The rise in earnings was accounted for mostly by the manufacturing group. For the second year in succession, the manufacturing group earned more and provided for a larger amount of reserves; total proportionate earnings of these companies increased from Rs. 13 crores in 1958 to Rs. 16 crores in 1959 while the reinvested profits went up from Rs. 5 crores to 7 crores. The overall expansion in investment activity and improved business conditions have had, in general, a favourable effect on earnings, particularly of the manufacturing companies. As could be expected, because of the Government's restrictive import policy, these industries have, of late, enjoyed a sheltered market in India for their products. The plantations group which comprised mostly tea companies,

presented an encouraging position, unlike in the preceding two years. These companies had to draw sizeably upon their accumulated earnings in 1957 and 1958 with a continuous fall in their earnings. In 1959, however, they earned more and retained a still larger share of these earnings by reducing their distribution of dividends, etc. In the case of the petroleum group, retained earnings were higher despite a reduction in total earnings. Of the aggregate earnings retained in 1959, manufacturing and petroleum groups together accounted for over 85 per cent.

The improvement in net foreign investment mentioned at the outset was almost entirely due to a sharp fall in the level of capital repatriation in 1959 to Rs. 14.8 crores from 24.4. crores in 1958. As was the case in the preceding year, the bulk of the outflow in 1959 was in respect of the petroleum industry which fell considerably from Rs. 21.9 crores to Rs. 12.9 crores.

Table No. 58

Inflow by Field of Investment 27/

(Rupees in Crores)

	Petroleum	Manufacturing	Others	Total
1956				
Gross	12.5	18.1	12.7	43.3
Net	12.5	15.8	8.7	37.0
1957				
Gross	17.6	38.8	2.6	59.0
Net	17.5	36.4	-3.9	50.0
1958				
Gross	6.2	35.9	10.0	52.1
Net	-15.7	34.6	8.8	27.7
1959				
Gross	15.2	33.0	4.7	52.9
Net	2.3	32.1	3.7	38.1
Outstanding investment at the end of 1959	120.7	250.7	239.3	610.7

27/ Reserve Bank of India Bulletin, P.676, May 1961

Foreign private investment in India was traditionally concentrated in plantations, trading and transport. But in recent years, investment in manufacturing, including petroleum refining, has become more important. Of the total investment in trading over Rs. 800 million was in oil distribution. Similarly oil refining was the most important manufacturing industry, though accounting for only about a sixth of total investment in manufacturing. The U.K. remains by far the largest foreign investor in India, owning over 80 per cent.[28/] of total foreign capital, and still it is the main source of new funds for direct investment supplying 154 million out of a total of 243 million rupees in 1956. U.S. was the next most important investor with 71 million rupees. About three quarters of total private capital in India in 1956 was derived from retained earnings, which were Rs. 179 million, of which 90 million was reinvested by the petroleum industry and Rs. 44 million in manufacturing companies.[29/]

The colonial pattern of direct investment in economically backward areas is characterised by production of primary commodities for export to the industrial creditor countries. In these areas, foreign business enterprise is attracted for the production of raw materials for export markets, because domestic markets do not afford any strong inducement to investor.

Causes of Decline of Private Foreign Investment in the Post War Period

The flow of private foreign capital to countries of the region was exceedingly low during the early post war years, owing chiefly to changes in the political situation and the emergence of nationalist Governments leading to uncertainty regarding the economic policies of some newly independent countries on the one hand, and to

28/ Reserve Bank of India Bulletin, September, 1958, P.1019 Statement IV

29/ U.N., The International Flow of Private Capital, 1956-58, P.46, 1959.

the need of economic rehabilitation, the cautious attitude of private investors, and the other opportunities open to private investors in the capital exporting countries on the other. Several creditor countries in Europe became debtor countries after the war and were not in a position to supply a substantial amount of capital to underdeveloped countries and capital from some countries in Europe was even repatriated from several newly independent countries of the region.

In their concern for political independence and for expansion of economic activities of the state, some countries of the region, e.g., Burma, India and a few others have followed a policy of nationalization of certain industries and of strict control over foreign investment. Sometimes, these controls have been tightened further as a result of the need to safeguard the balance of payments. In many countries of the region, Governments have clarified their policies towards nationalisation of private industries. Government guarantees against nationalisation of foreign enterprises and or private enterprises with foreign capital participation within a certain time have been established, either by special legislation or by a policy statement in Burma, Cambodia, Republic of China, Indonesia and Thailand.[30]

International political tension, which is based partly upon domestic instability and partly upon the differences in ideologies, is another cause for the decline of private foreign investment. Indonesia presents an instance on the point. Hence the collectivist structure of the economy does not fully take into account the dynamic forces operating in the economic life of the nation.[31]

30/ Economic Bulletin for Asia and Far East; Vol. VII.No.3, November 1956, P.59

31/ 'Indonesia's Economic Future'; Justus M.Vander Kroef-Pacific Affairs : Vol. XXXII, No.1, March 1959, P.59

Some of the other important obstacles to large increases in private foreign investment in South East Asian countries are : Inconvertibility of the currencies, fear of expropriation of property, discriminatory local taxes, and limitations on the use of foreign personnel. In the creditor countries, much capital is concentrated in the institutions such as life insurance companies, investment trusts and savings banks which cannot appropriately or legally take the risks of foreign investment. Besides, the United States one of the great potential exporting countries is itself undergoing rapid development, and returns on domestic investment are very attractive. " Moreover, the protective ~~taxxx~~ tariff policy of the U.S. has worked indirectly, but powerfully against her overseas private investment. High protection in one of the world's greatest markets has made it more difficult for other countries to earn dollars. This in turn, has led to legal limitations on the transfer of profits and to inconvertibility of currencies both of which deter investment from abroad."[32/]

In addition, direct investment in plant and equipment is subject to certain further risks, among which export and import quotas, multiple exchange rates and exchange controls, and extensive Government regulations probably head the list. Foreign owners of plant may be the object of discrimination or of special requirements to pay special taxes to hire a certain quota of native employees, to reinvest certain proportions of profits, etc. Foreign participation in ownership may at times be limited to a minority share. Finally, there may be general factors in the economic setting which are unfavourable, such as the shortage of trained personnel, inadequacy of the basic utilities, uncongenial business loans, high taxation, inflation and the like.

32/ An Approach to Economic Development; N.S.Buchanon and H.S.Ellis : P.345, (1955)

Some underdeveloped countries have adopted measures which are serious obstacles to new private investments. This is because of the unfortunate experiences with foreign investments in the past. These investments in the beginning were economic measures, but gradually they grew from small beginnings and their power enlarged as the amount of the capital invested and the number of foreign persons within those countries increased and subsequently, their principal usefulness was to ensure political controls which tended toward maintenance of monopolies. In most of the South East Asian countries the Dutch and the Chinese in the beginning came as small sellers of various goods and gradually they captured the home markets and then the political power. "It is evident that there is hesitation, if not general antipathy in many articulate Indonesian groups to the idea of foreign investment in the country; while at the same time, it is also realised......that under the present circumstances, Indonesia is unable to generate any sustained development unless it has any adequate capital.[33]

If private capital keeps aloof from some of the basic fields for development, it nevertheless exploits the immediately productive lines of investment and it would be difficult to dispense with these contributions to the current product of underdeveloped economies. Private capital investment brings with it managerial and technical talents not adhering to public capital. An important aspect of private capital is that it moves on sound business basis of mutual profit, without involving moral problems concerning the duty of a creditor country to supply capital. It, therefore, provides a firmer foundation for long run economic relations than does public capital.

Further, domestic entrepreneures tend to concentrate their activities in relatively a few sectors e.g., agriculture, trade and

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33/ 'Indonesia's Economic Future', Justus M. Vander Kroef; Pacific Affairs : Vol. XXXII, No.1, P.67, March 1959.

real estate owing partly to the lack of capital and partly to lack of experience. Foreign enterprise may pioneer a new industry, and thus demonstrate both its profitability and its capacity to cope with technical problems. Again, the foreign pioneer may be acting on his own, or he may be running a joint venture with domestic capital. It is sometimes easier to mobilise domestic capital for an industry if the domestic capitalists can rely on the association of foreign entrepreneurs experienced in the industry. Since the participation of such entrepreneurs suggests that the industry has fair prospects of profitability and will have good management.

Thus private foreign investment within a country can be favoured because : First, foreign investments permit the development of resources and industries of a country earlier than would otherwise be the case. New and underdeveloped countries lack both in capital and skills, and both can be developed with the help of foreign capital within a short period. Private foreign investments bring the capital and skills and by creating larger local income and a broader range of activity in the country they can hasten the process of local accumulation of both capital and skills. Second, foreign investments permit the development of the resources and industries of a country without tremendous sacrifices by the people.

At this stage it may be suggested that only that type of foreign private capital should be encouraged, which contributes to the national development in attaining higher productivity and higher standards of living. It should contribute to the development of the internal resources in underdeveloped countries, especially in the development of national industry and agriculture. It should not be made available in a manner or on conditions which are detrimental to the national interest and sovereignty of the underdeveloped countries, nor

should it be linked with any political or economic privileges for the capital exporting countries - the establishment of the military bases, etc.

Terms and Conditions of Providing Foreign Private Assistance

Private foreign investment thrives if there is national and international political security, price stability, exchange convertibility and freedom of trade. Potential investors, both local and foreign, in industrial projects in underdeveloped countries are especially concerned about the dangers of nationalisation. They see no point in investing their time and money in a new industrial project if it is likely to be taken over by the Government at the time it starts to earn profits. A country, which wants private investment in industry should be prepared to show its good faith by giving a general and long term guarantee against nationalisation. There should also be a provision, permitting early nationalisation, if desired, by payment of a bonus over and above fair compensation for the remaining value of the assets taken over. Such a guarantee may mean much in reassuring a nervous investor. Government should also clearly define its policy regarding the payment of compensation for industrial projects which it does nationalise at any time.

Most countries recognise the principle of equitable compensation in case of expropriation. The Government of Afghanistan has under consideration legislation under which arbitrators acceptable to both parties would settle possible disagreement on the amount of compensation to be paid in the event of an enterprise being nationalised or taken over in an emergency. As to the eventuality of expropriation, Thailand gives absolute assurance that the country will not resort to nationalisation of foreign enterprises admitted within its borders. Other Governments state that they will refrain from such action for a given period of time. In Cambodia, the limit is

set at ten to thirty years, depending on the economic usefulness of the enterprise concerned. Since 1958, foreign investors in Indonesia may be given guarantees against expropriation or nationalisation for twenty years for industrial enterprises and for thirty years for agricultural estates. In the same year, the Ceylonese Government announced that it would not consider nationalisation for the next ten years.[34/]

In countries having exchange controls, special provisions are made for the repatriation of foreign capital and for the transfer of foreign investment income. Most common are the provisions spreading over five years the repatriation of capital after the lapse of a period of one or more years. In the Philippines, the Central Bank policy is to allow the transfer abroad of profits in amounts ranging from 25 per cent to 100 per cent of the non-residents share in current profits, or from 20 per cent to 60 per cent of foreign capital invested, whichever is lower, depending upon the social productivity rating of the investment. This rating is established with reference to the enterprise's net contribution to national income or employment and to the effect of its activity on the balance of payments and on the supply of essential products.[35/]

Recently, some of the Governments of the capital exporting countries have also taken steps to guarantee the funds of the private investors, which they have invested in the underdeveloped countries. One such guarantee was given by the Government of the Federal Republic of Germany. At the end of 1958, it was announced that the Government is ready to set up a fund to guarantee private investors against the political and transfer risks of putting their capital in overseas ventures. The Japanese Government offers protection to entrepreneurs

34/ U.N. International Flow of Private Capital (1956-58), P.96, 1959.

35/ Ibid : P.97

against loss of capital and blocking of profits abroad, in case of overseas investments, which are considered by the Government as making a remarkable contribution to the improvement of international payments. In the United States, the 'Investment Guarantee Programme' of the International Cooperation Administration enables investors to obtain a Government guarantee against non-commercial risks for their investors in countries having signed an investment agreement with the U.S. The Mutual Security Act of 1956, in addition to increasing the authority to issue guarantees from $ 200 million to $ 500 million and extending it from April 1962 to June 1967, added to the programme guarantees against loss by reason of war. During the three years 1956-58, fifteen investment guarantee agreements or amendments were negotiated between the United States and other countries, seven new countries joined the programme - Jorden in 1956, Cuba in 1957, Afghanistan, India, Iran, Republic of Viet-Nam and Ghana in 1958 - two agreements were amended to include expropriation guarantees and six agreements were amended to provide guarantees against war risks.[36/]

The main deterents to the free flow of foreign investments into India are : The high rates of taxation, some alleged discrimination against foreign firms operating in India exposed to double or even triple taxation, and the apparent absence of equity in treating preferentially certain industries which earn foreign exchange.[37/]

The slow growth in industrial output in the past three years and the recent depressed conditions in the capital market in India have called for positive fiscal incentives to stimulate the growth of the corporate sector. Corporate taxation has been re-modelled, particularly in 1964 to enable the companies to plough back into

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36/ Ibid : P.100
37/ See Commerce, Bombay, P.187 , 4th February, 1961

business a larger magnitude of profits and to create a better climate for increased inflow of foreign equity capital. Inter-Corporate dividends have been exempted from super tax to encourage the inflow of foreign equity capital into Indian companies. The incidence of Corporation taxes on foreign companies operating in India through their branches in respect of their income other than royalty income and fees, has been marginally raised from 63 per cent to 65 per cent, but this must be viewed against the reliefs given by the exemption of inter-corporate dividends from super tax and the fact that the Sur-tax is not by and large applicable to them. Private limited companies engaged in priority industries have been subjected to a lower rate of super tax, though private limited companies have to pay a higher rate of super tax. Care has been taken to see that the increase in super tax on private limited companies may not adversely affect the flow of foreign equity capital into priority industries. For this purpose foreign companies have been allowed a concession of income tax on their dividend income received from private limited companies engaged in priority industries.[38/]

In general, the most important benefits that ~~they~~ are being offered to a growing economy are in the tax field. Many countries have introduced in their tax systems features favouring expansion of existing enterprises, through liberal depreciation and related allowances on one hand, and discrimination in favour of reinvested as compared with distributed profits on the other. These measures are often complemented by exemptions from import duties on machinery and raw materials and by various preferential rates of exemptions with regard to other direct levies. Some countries give complete exemption from income, business, and property

38/ For details see ECAFE Bulletin, No.5, Vol. XIII, June 1962. Also see Reserve Bank of India Bulletin, March 1964.

taxes for a period usually varying from five to ten years. Others limit the exemption to a specified rate of earnings on the total investment to skim off any extreme excess profits which arise because of monopoly or other special circumstances. Some countries allow an exemption, which is greater for the first few years, then gradually declines until the company pays normal taxes by about the tenth year. Still other countries give greater exemptions to industries, which are in categories regarded as being of high national economic priority, or to those, which use local rather than imported raw materials.[39] In Ceylon, profits are exempted only upto a certain percentage of return on the invested capital.[40]

Until recently, capital exporting countries were mainly concerned about avoiding double taxation of investment income, but in the last few years new measures favouring investment abroad have been adopted or have come under consideration, which, except those relating to the creation in domestic law or new legal entities for conducting business abroad have involved resorting to international agreement.[41]

In recent years Canada, U.S., and U.K. have continued to expand their tax treaty net works. The U.S. concluded agreements with Pakistan in 1957.[42]

In 1957, the Federal Republic of Germany adopted a system of crediting foreign taxes against domestic liability similar to those in existence in the U.S. and the U.K. But in most of the countries which are capital exporting e.g., Belgium, France, Italy, the Netherlands, and Switzerland, the long established practice is not to tax income

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39/ Industrial Development-A Guide for accelerating Economic Growth; Murray D.Bryce (1960) ; P.677
40/ U.N.,International Flow of Private Capital (1956-58); P.98,1952
41/ Ibid : P.100
42/ Ibid : P.102

from the active conduct of business abroad or greatly to reduce the tax on such income; corporate profits from business carried abroad through a permanent establishment are generally exempt. Foreign investment income received from abroad in the form of dividends is generally taxable, but dividends received from foreign subsidiaries are exempt or taxed at a reduced rate. Sweedon, whose legislation does not provide a systematic relief from double taxation, has recently signed agreements with Ceylon (1957), India (1958), Pakistan (1958), Under these agreements corporate profits derived from permanent business establishments in these countries are exempt from Sweedish income tax. The agreement with India and Pakistan also provides for the exemption of inter-corporate dividends received from these countries.43/

Several countries have entered into bilateral agreements which facilitate the entry and provide protection to foreign private capital. The net work of bilateral treaties was further extended between 1956-58.

Conclusion

There can be no two opinions on the point that a speedy development of a capital scarce economy is possible only when foreign assistance in the form of loans and grants is supplemented by a fairly large inflow of private capital investment. Such an inflow depends more on the climate that exists in the recipient country than on the conditions obtaining in countries from where capital moves out. The climate is essentially conditioned by the economic and fiscal policies of the administration.

In India, the outlook for foreign investment is favourable as witnessed by the freedom of remittances of profits and dividends, as well as repatriation of capital, double taxation agreements entered

43/ Ibid : P.103

into with the Governments of some countries, and the desire to participate in the U.S. Government sponsored scheme for insurance against risk of nationalisation, expropriation, etc.

Private investment abroad opens business opportunities to the capital exporting country, while, on the other hand, an inflow of resources and skills from abroad enables the recipient country to develop its productive capacity to diversify and stabilise its economy to improve its general standard of living and to increase its exports and imports with greater rapidity and less cost than if it were to rely exclusively on its own savings and technical experience.

The major concern of a foreign investor is to ensure that he will be able to convert into foreign exchange his dividends, fees and capital funds arising, if he sells all or part of his interest to local investors or if the property is nationalised. Realizing that the country may be experiencing foreign exchange shortage at the time he may need to convert local funds into free foreign exchange. He may be willing to invest only if the country is prepared to give him a clear guarantee of his conversion rights. Such guarantees should be given to the country for projects which are of economic importance. To prevent abuse, guarantees should be subject to limitations as to timing or amount.

A country's capacity to attract foreign capital in adequate quantity on reasonable terms depends mainly on : First, that natural conditions and resources offer remunerative possibilities for economic activity, second, that political, social, economic, fiscal and administrative institutions and conditions permit the secure and remunerative conduct of business, that foreign capital and skills are allowed to enter and are granted fair treatment, that domestic

enterprise, capital and labour are able and willing to cooperate with foreign enterprise and to use foreign capital and skill.

External financial obligations must ultimately be paid for by exports of goods and services. The need for increased exports is one, which the country receiving capital should consider when planning not only its production but also its general economic and financial policy.

Imported capital must be used for productive purposes. The transfer capacity of a capital importing country does not depend only on its trade with the capital exporting countries, but also on its and their trade with the rest of the world. Any check to multilateral trade is likely to reduce the transfer capacity of capital importing countries, and consequently the return on foreign investments which thus decline in value while new investments are discouraged. The success of international investment depends on measures of international economic policy and the negotiations of agreements tending to restore a world wide multilateral trading system, so as to open transfer routes from debtor to creditor countries through another country.

Double taxation on foreign investments as far as possible should be avoided. From a revenue standpoint, capital exporting countries will generally be in a more favourable position to grant relief from international double taxation than capital importing countries. To constitute an enduring contribution to economic and social advancement, private foreign investment should be mutually advantageous to both capital importing and capital exporting countries.

The underdeveloped countries to-day are in a poor bargaining position in respect of the acquiring of the foreign capital, because, much capital is needed by a great many countries, while only

a limited amount of capital can be had, and that too from a few countries.

The broad conclusion that emerges from the foregoing discussion is that underdeveloped countries need foreign private capital. They will have to increase their export capacity to attract it. It is necessary for them to be perfectly clear about what the foreign investor wants and about the extent to which they can or should satisfy him. Some of the principal factors affecting the foreign investor are those which concern him at home, viz., the favourability of the market, the promise of ~~the~~ profit, the opportunity for capital gains, the level of taxation, freedom from restrictive legislation and the attitude of the Government. In addition, foreign investment raises the question of the conditions under which foreign managerial personnel, staff, and technicians will serve. It also brings to mind possible difficulties in importing the necessary machinery, parts and materials, the likelihood of discriminatory legislation, etc. Broadly speaking, the foreign investor expects some thing more than he can get at home for his investment coupled with the assurance about the safety of his investment. Given this, foreign investment will flow to underdeveloped countries in abundent measure.

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CHAPTER VII

INTERNATIONAL INSTITUTIONS AND ECONOMIC GROWTH

The developing countries require a continuous flow of external aid for developing their economy. The trade policies of the industrialised countries, the emergence of regional trade groups, the unfavourable movements in the terms of their external trade are factors to which attention has to be paid. A large portion of their export earnings are being absorbed by the servicing charges of their external debt. Grants and long term loans at low rates of interest are, therefore, necessary to speed up their developments.

Bilateral and Multilateral Aid

Aid may be from private sources or on Government level. In the post-war period, private capital is not adequately forthcoming, particularly in the field of economic and social infra-structure like roads, schools and hospitals. Hence resort must be had on a large scale to funds from public sources. The choice here lies between bilateral or multilateral aid. In the former case the recipient country has to utilise the aid by purchasing goods in the donor country and this aid is subject to political pressure and may be utilized even for low priority projects. Political influences may even misdirect development aid and this aid may not be consistent with economic objectivity. At times it may lead to the postponement of essential reforms in the fiscal or monetary policy of the recipient country. Multilateral aid, when professionally equipped and independent of political pressures offers better advantages than those of bilateral assistance.

International aid organisations enable the underdeveloped countries to draw on the experience of other nations. The developing nations can buy goods in the cheapest markets. International organisations like the Bank and the I.D.A. can apply the real criterian to the practical needs of each particular case. They can insist that the aid must be used for sound projects and they can also require that the recipient country should also make efforts of their own.

Thus objectivity can be expected as a result of the aid provided through an international agency. The recipient country is likely to take a more objective attitude towards the use and repayment of the aid than it is likely if the aid is bilateral. An international agency can also provide advice on all aspects of development planning which will be based on experience drawn from a wide area. The resources and knowledge of industrialized countries can be effectively used in this form of aid. An institution like the IBRD can raise development funds in many nations in the private markets. Hence multilateral aid programmes exert a healthier influence than multilateral lending, both upon the recipient country and upon international relations.

The International Monetary Fund

The role of the international financial institutions has to be assessed in this context. The I.M.F., The I.B.R.D. and its affiliated institutions - the I.D.A. and the I.F.C. have to play a leading part in providing finance and technical know-how for the economic growth of developing economies. The original purpose of the Fund in 1946 was to promote international monetary cooperation and to facilitate the expansion and balanced growth of international trade. The Bank was to assist in the reconstruction and development of territories of the members by facilitating the investment of capital

for productive purposes.

The Fund extends assistance of a financial and technical nature to members. It holds annual consultations on the balance of payments and related problems with practically all its members, whether they have exchange restrictions or not. In many of the developing countries, inflation is the major problem. In India, for instance, after 1956, since the beginning of the Second Plan, holding the price line has been the major problem and the wholesale price index has risen by over 35 per cent. Whatever the reason, many Governments still find that monetary expansion is an easier road to travel when coping with budgetary and other difficulties than is the road of financial stability. Underdeveloped countries with inadequate savings and resources try to increase them both for the use of the Government and for the private sector. Experience, however, indicates that inflation merely leads to a reduction and misuse of real resources and savings. In the developing countries, it is not possible to establish a basis for economic growth, which will raise living standards and bring hope to the masses unless Governments try to bring continuing inflation to an end. Only then can an enduring basis be established for continuing growth. The I.M.F. is making efforts to help the developing members to fight inflation. It has to help members to devise policies, to create financial institutions and tools and to test and perfect them by trial and error in the field of action.

The problem of short-term and medium-term foreign debt of the developing countries is placing a great strain on their economies. Countries, which are short of capital, are eager to accept foreign capital in all its forms. The ability to service foreign debt, particularly of a short-term and medium-term character is necessarily limited. In many cases, foreign indebtedness absorbs a large part of

the total current foreign exchange earnings. The cost of excessive external borrowing is high, both in regard ε to the price of the commodities obtained and the rate of interest paid. Carried to the extreme, it leads to internal and external financial crises and it brings about interruptions in the orderly process of growth. The Bank and the Fund point out dangers of excessive short-term foreign debt. They have also done much to bring about a healthier pattern of foreign debt. In the case of India in the Third Plan about Rs. 500 crores will be required for repaying foreign obligations out of the estimated amount of Rs. 3,200 crores of foreign exchange requirements.

The main problems bearing on the activities of the Fund in relation to the members, particularly in underdeveloped countries relate to

(a) Access to the Fund's resources;
(b) Policies on the use of the Fund's resources;
(c) Currencies to be drawn;
(d) Replenishment of the Fund's resources through borrowing; and
(e) Capital transactions.

Regarding access to the Fund's resources, a country facing balance of payments problem can turn to the Fund for assistance. The financial institutions and the exchange markets regard this as an appropriate course of action and an effective basis for supporting the currencies. In many cases its own assistance has been supplemented by credits made available from other sources.

The Fund has also laid down policies and practices for the use of the resources. So far the financial assistance did not go beyond 100 per cent of a member's quota. Now, in several cases the Fund has agreed to grant assistance to 125 per cent.

The Fund's assistance has also been used for capital transactions. Capital movements may be substantial even under exchange restrictions. They can assume high proportions under

conditions of convertible currencies. The Fund's resources have been used in situations involving capital transfers. The Fund's resources can be used to alleviate pressures brought about by capital transfers. If a country facing a disequilibrating outflow of capital were to apply for the assistance of the Fund, one of the criteria, which the Fund would apply would be to satisfy itself that appropriate measures were being taken to overcome the balance of payments difficulties and that the assistance given by the Fund would be repaid at the earliest opportunity, say, upto 5 years after the drawing. In 1961 and 1962, capital transfers were responsible for a considerable part of the pressure on the currencies of the U.K., South Africa, Mexico and Canada.

Regarding borrowing arrangements, it may be said that the Fund can borrow supplementary resources in currencies of ten member countries amounting to six billion dollars in all. In January 1962, the terms and conditions for such borrowings were laid down as also the procedure.

Many countries have received financial assistance either through direct purchase of currencies or in the form of stand-by arrangements. Total purchases during the year 1962 came to$678 million and repurchases to $ 1,749 million, Stand-by arrangements during the same period came to $ 1,579 million. Under new stand-by arrangements granted by the Fund in the period, an amount of $ 1,579 million remains undrawn.

Fund's activities

The variegated activities of the Fund are, of course, by no means limited to the granting of financial assistance. Firstly, the Fund also has jurisdictional powers with regard to par values and rates of exchange. Secondly, the annual consultations under

Article XIV of the Fund Agreement, as well as those which are now conducted with Article VIII countries, form a very considerable part of the Fund's work. Such consultations are of a great advantage to the member countries because they provide an occasion for the members of the various Government departments to make a comprehensive review of the country's economic and financial problems in close contact with internationally trained experts. Besides this, the consultations also provide the Fund with up-to-date information about developments in the various member countries and about the policy intentions of the authorities. Such consultations help the Fund in responding rapidly to requests from its members including that for financial assistance. Finally, over the last few years the Fund has also provided technical advice and assistance to a large number of countries through resident advisors and in other ways. Thus the Fund's expanding training programme under which officials from member countries attend courses of instruction provided by the Fund in its special spheres of activity is of particular advantages to new member countries.

It is one of the advantages of the Fund that its financial assistance can be ~~appointed~~ given precisely to those situations where difficulties in the balance of payments occur. The assistance helps the countries to take corrective measures and also helps to avoid the emergence of a chain reaction, which could set in if the situation were not taken in hand. These are both real contributions towards ensuring stability in the world's monetary system, and toward the maintenance of an adequate level of liquidity.

Many developing countries have very low reserves of foreign exchange, but what these countries need most is long term capital to finance development programmes. Although many of them would no doubt be wise to pay some attention to building up their reserves to a safer

level, whatever efforts may be made by them to do so will presumably not cause any appreciable difficulties from a general liquidity point of view.

But as regards the industrial countries, there are certain basic developments which point to the restoration of a more enduring equilibrium between the economies of most of these countries. After the convulsion brought about by a world war, intensified in some cases by the changes in the post war reconstruction period, it is not easy to establish harmony between costs and prices, or a proper money supply, or the appropriate conditions in the long term and short term capital markets in the domestic economies of individual countries. It is even more difficult to attain this kind of equilibrium between the economies of different countries. Such an equilibrium was never really attained after the First World War and after the Second World War there have been several periods of intense monetary tension, indicating the continuance of an unbalanced position.

As far as changes in costs are concerned, resulting from the interrelation of wage rates and productivity, there has recently been little, if any, cost increase in most sectors of the U.S. economy, while in several Europeon countries wages have risen noticeably more than productivity, with a consequent pressure on costs. The difference has been sufficiently important to have an impact on the balance of payments. These problems are more acute in developing countries.

The present monetary structure can be effectively maintained on a foundation of stable exchange rates, thus providing a reliable basis for further economic development and for the shaping of official policies. But this requires a continuous effort which should be pursued in an atmosphere of greater confidence. It may be pointed out here that what has been achieved already may well come to exercise an influence on Government policies and actions in a number of ways.

Exchange Stability

Firstly, since a much better balance has been attained in the international payments situation, it follows that the extent of the remaining mal-adjustments in the cost and price and interest rate relations, as reflected in capital movements between individual countries, has been greatly reduced. Therefore, there is reason to believe that further corrective policies, in so far as they are still needed, will not have to be so extensive that their effects should prove too disturning, nationally and internationally.

Secondly, the efforts already made, and those which will be required, will prove successful in ensuring a stable exchange rate structure without any alteration in the present price of gold. The now ample monetary reserves of so many individual countries, together with possibilities of resorting to reciprocal central bank credits and ready access to the increased facilities of the International Monetary Fund, provide formidable lines of defence against any pressures that might arise in the future.

Thirdly, with the improvement in the general situation, it should be possible to avoid policies which reflect a distrust in that situation and which might detract from the efforts to solve real problems.

Fourthly, in view of the improvement which has taken place, it seems that in many countries the monetary authorities could now regard fluctuations in the level of their monetary reserves with growing equanimity.

These policies are primarily concerned with the maintenance of exchange stability. But as regards the financing of international trade is concerned, it is done through the credit mechanism in individual countries. Under the old gold standard, the creation of credit in the

individual countries was closely linked to movements of gold, and in quite a number of countries changes in the volume of credit have continued to depend to a large extent on changes in their balances of payments, but it does not mean that no increase in the credit volume could occur without an addition to monetary reserves. In U.S., credit has been expanding over the last ten years despite a considerable decline in the gold stock. In Germany too, credit has expanded over the last two years without an increase in reserves. In many countries, modern techniques, not least through the initiation of open market operations, have given greater flexibility to credit management than was possible previously. These techniques can, of course, be further adapted, and new instruments may be developed or evolved.

Promotion of Exports

One of the most pressing problems confronting the developing countries, and no less for the newly independent countries, is the need to pay particular attention in the development of their economies to the promotion of exports. These countries would be greatly helped by a reduction of artificial barriers impeding the free flow of trade and payments with other countries, and by mutual arrangements designed to make the best possible use of the scarce resources at their disposal. For the newly independent nations there is a clear advantage in close economic and monetary cooperation among countries that historically have belonged to the same currency and trading area, and even among those that have belonged to different currency and trading areas. At the same time, it is the responsibility of the developing countries to pursue policies which facilitate exports. It is at the same time the responsibility of the industrial countries to pursue liberal trade policies, opening their markets to imports from less developed areas. By such policies, they would in a constructive way, contribute to the welfare of the developing nations - old and new.

The Need for Long Term Resources

Financing of development programmes of developing countries is, of course, of another character - long term resources being needed, largely related to specific programmes. While the Fund's financial assistance is related to balance of payments problems, and is repayable within not more than three to five years, it does not mean that the Fund is not interested in the whole complex of these problems as both internal and external financing of development has obvious monetary repercussions. Concentration on non-inflationary sources of financing is more and more found to be the key to sound development, and fiscal and credit policies are, therefore, essential elements in development planning. In these countries a greater reliance on inflationary financing for promoting development almost inevitably brings in its wake a flight of domestic savings and diversion of investment into non-essential lines, a reduction in capital inflow, a decline in export earnings, and distortions in the economy, all of which lead to a discouragement rather than an encouragement of the healthy economic growth, which is a basic objective of the Fund's work.

In recent years, for providing financial assistance to developing ~~a~~ countries, consortiums have been set up under the leadership of I.B.R.D. and also the Organisation for Economic Cooperation and Development. I.M.F. officials have taken part as observers in meetings of these consortia. But the Fund should associate itself more closely with these endeavours and generally with development efforts, and through examination of each situation in an international setting would seem to provide the greatest assurance that economic considerations will prevail, and thus waste will be avoided.

I.B.R.D. and Affiliates

At this juncture it is necessary to give a short account of the part played by the I.B.R.D. and its affiliates - the IFC and the IDA in promoting economic development of the poorer nations. The Bank was established and authorised to make or guarantee loans for productive reconstruction and development projects, both with its own capital funds and through the mobilisation of private capital.

Its capital structure as designed at ~~the~~ Bretton Woods provided that only 20 per cent of each member's subscription could be called and used for lending. Out of this 20 per cent capital subscription, two per cent was to be paid in gold or dollars and the 18 per cent was to be paid in the local currencies of the member countries. The remaining 80 per cent was to constitute a guarantee fund serving as backing for the Bank's borrowing operation. It was not to be paid, but could be called in by the Bank only when required to meet its obligations. The sale of the Bank obligations to investors was to constitute its main source of lending funds. The payment of 18 per cent in local currencies was due to the shortage of dollar and gold resources with member countries.

This capital structure placed a restriction on the lending capacity of the Bank inasmuch as the 18 per cent payment remaining in local currency could be lent with the consent of the countries concerned. Many of the countries including Britian were able to release the 18 per cent portion only in 1959.

The Bank has facilitated the investment of considerable amounts of private capital by arranging for the direct participation of private commercial and investment banks in the early maturities of its loans. It has also tapped the capital markets through sales of its own bonds, and in the case of the countries which have ~~xxxxx~~

managed to establish or re-establish their financial standing, has arranged for the floatation of bond issues in the market in conjunction with its own loans. Besides sales of bonds the Bank has attracted to-date $ 590 million equivalent from some 150 commercial banks, Insurance Companies, and other public and private financial institutions which have participated in Bank's lending without its guarantee in one way or another. Another $ 280 million in principal repayments have been made directly to the Bank and have become available for further lending.

To increase its lending capacity recently, the Bank decided to increase its capital from $ 10 billion to $ 21 billion and each member's subscription was to be doubled. The subscription of 17 member countries including Canada, Germany, and Japan has been increased by more than 100 per cent. Except in these cases this increase has not implied an increase in the cash payments from member countries to the Bank.[1]

" The Bank's emphasis from the beginning was not ~~tx~~ so much on what the Bank could lend directly out of its paid-in-capital as on the concept of the Bank as providing into the international field. It is a unique feature of the Bank that although it is an inter-Governmental Organisation, it must rely upon the private investment community for most of its financial resources.[2]"

The Bank has been overcautious in the matter of grant of loans. Its charter contains many provisions to safeguard the interests of the creditor and to enable the debtor to utilise the capital borrowed for productive purposes and, except in special circumstances, it must finance the foreign exchange requirements of specific projects

1/ I.B.R.D., Annual Report, 1958-59, P.9
2/ The International Bank for reconstruction and development 1946-53, Baltimore (1954); P.6

of reconstruction and development "whether as guarantor or lender. The Bank was required to make a prudent assessment of the prospects that loans would be repaid. Normally it was to associate itself with the financing of specific projects. It was to study and choose those projects for their usefulness and urgency to the country concerned, and it was required to exercise the necessary care to insure that loans were applied effectively to the purposes for which they were made. With allowance for special circumstances, the Bank was to guarantee or make loans in foreign exchange rather than in the domestic currency of the borrower."3/ Thus, the Bank's charter contains a number of protective provisions governing loans to ~~thx~~ be made or guaranteed by it. It was stated that "the merits of all projects financed must be carefully studied and arrangements made designed to assure that the most useful and urgent projects are dealt with first."4/ Loans for private parties must be guaranteed by the Government of the member country in whose territory the project is located. In making loans the Bank is to act prudently and has to see that the borrower or the guarantor as the case may be should be able to meet its obligations under the loan. The Bank has to make arrangements to ensure that the proceeds of each loan are used only for the purposes for which the loan was granted consistent with considerations of economy and efficiency and without regard to political or other non-economic considerations. The charter of the Bank also provides "the prohibition against 'tied' loans; that ~~x~~ is, the Bank is to impose no conditions requiring the proceeds of its loans to be spent in the territories of any particular member or members. The funds must, however, be spent

3/ Diplomacy of Economic Development, 1959-60; Eugene R. Black; P.61
4/ The International Bank for Reconstruction and Development 1946 to 1953; Baltimore, 1954, P.7

in one of the member countries. The second is a requirement that the Bank must be satisfied, before making or guaranteeing any loan, that in the prevailing market conditions the borrower would be unable to obtain the loan from private sources under reasonable conditions.[5]"

Lending Operations of the Bank

It was in 1949 that the Bank started operating in less developed countries of South and East Asia. India was the first Asian country to receive a loan from the Bank in August 1949. In making loans to underdeveloped countries, the Bank had to face problems very different from those of Europeon reconstruction. "In these countries, the task was not simply to restore the missing components to economies already mature; it was to strengthen foundations. A dearth of basic services was (and still is) the major physical obstacle to increasing production and raising living standards in the less developed countries. Lack of these services put severe limits on productivity, on income, and on the willingness to invest. The lack of dependable and economic transportation restricted the size of markets both for industrial and agricultural ~~xxx~~ production, and kept regions with promising natural resources beyond the reach of development. Deficiencies of electric power supply conscicuously handicapped industrial growth.[6]

As stated by Mr. Eugene R.Block,[7] "to strengthen basic services and so to set free new productive energies has been the main objective of the Bank's development lending from the onset." Hence the Bank has made more loans to develop electric power than for any other purpose, but it has lent as much for highways, railways, ports and other means of transportation. An analysis of loans taken by India from the Bank highlights the fact that she has received aid for a variety of purposes envisaged by the Bank. A very few other borrowing countries of Asia

5/ Ibid :
6/ Diplomacy of Economic Development; Eugene,R.Black, P.63.
7/ Diplomacy of Economic Development; 1959-60, Eugene R.Black,P.63

have had the benefit of the Bank's assistance for such a wide range of purposes. In addition to power, railways, ports, airlines and agriculture, India has received loans for the steel industry and development banking. The first loan of $ 75 million granted to the Tata Iron and Steel Company is the largest industrial loan awarded by the Bank to private enterprise. Secondly, the public ~~and~~ sector and the private sector both have benefited from the Bank's assistance. The public sector is the recipient of fourteen loans of the aggregate value of $ 395.6 million and the private sector of eight loans of the aggregate value of $ 204.5 million upto 1962 . This again is a distinction which India shares with a small number of the borrowing countries.

In the beginning the Bank's development lending was slow to gather momentum. Till 1953 only three countries - India, Pakistan, and Thailand - could qualify for the Bank's loans. Thereafter, its lending operation spread over to other Asian countries also. Philippines got her first power loan in November 1957, while Malaya qualified for receiving the loan in September 1958. India received the bulk of loans during the second Plan period. So far, Sixteen loans amounting to about $ 496 million have been given to India. Bank has a direct concern with the level of interest rates in the various bond markets of the world, because the rate of interest the Bank charges to its borrowers reflects the cost of its own borrowing. At present the Bank is charging six per cent rate of interest. Even at this rate most of the countries are finding it difficult to borrow on a large scale. Besides, conventional development loans are made in foreign currency and have to be repaid in the hard currency. This is difficult for the less developed countries for many reasons. The large decline over the past few years in the prices of primary food stuffs and raw materials has had serious repercussions on the borrowing capacity of the less developed countries.

According to Mr. Eugene R. Black "the most external help can do is to help them to help themselves." The help of the Bank to underdeveloped countries will increase if the terms of repayment are changed so as to accept repayment in local currency or in goods and services.

From the beginning, the Bank has been interested in questions that go beyond the particular project proposed for financing. One of the questions is, whether the project itself, judged against the need of the economy as a whole, promises enough return to justify borrowing on the scale suggested, another is whether the necessary complements to the project exist in the economy. "Moving carefully from problem to specific problem, the Bank had to elaborate its own policies and mark out its own trial."[8/] The Bank has been at least equally concerned with the economic environment in which its loans are to be put to work...... It has as a matter of course consistently urged attempts to settle defaulted external debt, to put economic and fiscal policies on a sound footing, and to direct public investment in such a way as to promote rather than to obstract or displace, the flow of private capital.[9/] However, in the underdeveloped countries of Asia, the need for outside capital is pressing but so is the need for creating the conditions and supplying the skills necessary for using capital more effectively than it has been used in the past.

Other Services

In any case, what is still notable in the Bank's performance, is not merely the volume of finance provided, but the growing attention paid to the development of skills and institutions on which economic progress so much depends. In almost every field of technical assistance

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8/ Ibid : P.65
9/ Ibid : P.67

it has entered, the Bank is making efforts to broaden and strengthen its assistance. The Economic Development Institute is giving more courses to more officials in more languages than ever before; the Development Advisory Service is deploying its experts in a rising number of countries; the help given to prepare the important development projects has increased.[10/] In addition, the Bank has established contacts with industrial development banks, public and private, in a large number of countries.

For some years the Bank has been pursuing a policy of joint operations by arranging to make its loans coincide with an approach by the borrower to the capital market for additional finance often for the same project.

Loans to Private Parties

The Bank's charter provides that it will not make loans when private capital is obtained on reasonable terms. For making loans to private concerns, the Bank insists on the guarantee of the Government of the borrowing country concerned. Besides, the Bank does not finance the whole cost of any project of programme. The Bank's normal lending takes the form of loans of foreign exchange to finance that part of the project or programme which represents the requirements ~~x~~ for imported goods and services. Most countries will have within a reasonable time direct import requirements for productive projects or programmes of a type suitable for Bank financing in an amount as large as, or larger than, the probable capacity of the country to service foreign debt. In such cases the use of Bank loans to cover only these direct import needs meets the development financing requirements of the borrower and, at the same time, assures that the foreign exchange furnished by the Bank

10/ I.B.R.D., Press release No.407, June,27,1955, 'Malayan Mission Report'. Press Release No.600, September,1959, Report on Thailand Economy and also the Economic Development of Ceylon : 1953,March

will be used for directly productive purposes. Moreover, the policy of requiring such countries to meet local currency expenditures without drawing upon their limited external creditworthiness is a practical way of assuming that they will mobilise their own resources to meet a substantial part of the cost of projects or programmes, which the Bank is helping to finance.

Further "the Bank's international character, its reputation for objectivity and expertness in finance led it logically but unexpectedly into the field of international mediation."11/ The Bank has promoted economic growth by playing a significant role in mediating economic conflicts among member nations. Late in 1951, the Bank made use of its good offices to help the Governments of India and Pakistan to evolve a Plan for sharing and developing the waters of the Indus river system. "Thus the Bank has shown itself capable of adapting itself to changing circumstances : of altering its methods of operation and starting fresh experiments in international organisation..... It retains the idealism and enterprise with which it started and has succeeded in mixing this with hard-headedness and throughness. Few international organisations have maintained so lively an atmosphere or one so favourable to the purposes for which they were established."12/

Recently, the Bank has moved from reconstruction to development lending. The Bank has assisted a few of its member countries in the establishment of the development banks and has also provided the foreign exchange needed for their operations. A principal reason for the International Bank's original interest in development banks was that they offered a practical solution to the difficulties the Bank encountered in financing small private industrial projects directly. Where the projects were many and the amount sought was small, the

11/ Diplomacy of Economic Development : Eugene R. Black, P.70
12/ Ibid : P.71

Bank could not afford to undertake the detailed technical and creditworthiness appraisals which are a normal preliminary to a loan. Moreover, effective appraisal of such projects called for a greater knowledge of local conditions and the business standing of the sponsors than the Bank possessed or could readily acquire. More important, it was not feasible for most private enterprises to obtain, and many were reluctant to accept, the Government guarantee required by the Bank's charter when the loan is made to a non-Governmental borrower. However, these difficulties were avoided or surmounted when the borrower was a local financial institution, which could readily obtain a Government guarantee, could select the most promising enterprises for financing out of the proceeds of the Bank's loan, and could undertake the necessary technical and financial appraisals.13/ Thus the Bank by establishing its contacts with industrial development banks in a number of countries, has come to know something of the numerous small enterprises in underdeveloped countries. Such enterprises not only contribute to the creation of new jobs, but they also serve as capital saving enterprises. In large scale industries, which grow in urban areas welfare schemes and housing absorb a large amount of capital, which cannot be postponed. Small industries grow in rural areas and utilise local resources and being widely dispersed do not require a large amount of investment in welfare activities. In keeping contact with development banks in underdeveloped countries, the Bank is, therefore, rendering a very useful service. The Bank has accorded loans to development banks. Upto September 25, 1959 two loans amounting to $ 14.2 million were given to the Industrial Credit and Investment Corporation of Pakistan, and upto July 15, 1959 two loans amounting to $ 20 million were advanced to the Industrial Credit and Investment Corporation of India. Thus the Bank has helped to put the long term

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13/Problems and Practices of Development Banks; Shirley Boskey : PP.4 and 5 (1959)

financial institutions in underdeveloped countries on a sound workable footing.

The I.B.R.D. is the main agency, through which this international flow of capital from the developed regions to the underdeveloped regions can be and is being facilitated. The inflow of capital into underdeveloped countries was about $ 5 billion in 1959 and was higher than in 1956, though less than in 1957. This contributed to the financing of imports and enabled many less developed countries to avoid substantial curtailment of investment and to minimise reductions in their economic growth.[14/]

The International Finance Corporation

The International Finance Corporation is a new affiliate of the World Bank. The Corporation was set up in 1956 to extend loans in the developing member countries to private enterprise without Government guarantee.[15/] The loans from the Bank for private enterprise require Government guarantee. This condition restricts the utility of Bank loans to private enterprise. The Corporation is thus a great help for providing finance for private enterprise.

The purpose of the Corporation is to promote the growth of productive private enterprise, especially in the less developed countries. It achieves its aims by :

(a) Investing in productive private enterprises, in association with private investors and without Government guarantee of repayment, in case where sufficient private capital is not available on reasonable terms.

(b) Serving as a clearing house to bring together investment opportunities, private capital, both foreign and domestic, and experienced management.

14/ The Export Import Bank of U.S.A. and the U.S. Development Loan Fund are not strictly speaking international institutions inasmuch as their capital funds are subscribed by the nationals of U.S.A. but in one sence their loans have international repercussions inasmuch as these funds are made available for developmental purposes for long periods in underdeveloped countries.

(15) See First Annual Report of International Finance Corporation, 1956-57.

(c) Helping to stimulate the productive investment of private capital both domestic and foreign.

Thus the I.F.C. considers only those investment proposals whose objective is the establishment, expansion or improvement of productive private enterprise which will contribute to the development of the economy of the country in which the enterprise is located. Unlike the Bank, the Corporation does not investigate the developmental priorities of a project as against other possible investments in the same country, but wishes to satisfy itself that it has substantial economic value.

Lending Policy of the I.F.C.

During the initial years, the I.F.C. proposes to make investments in enterprises which are predominently industrial i.e., manufacturing, processing, and mining. It is not to make investment in social overheads like housing, hospitals and schools as well as in the basic public utilities like, electric power, transportation, irrigation, reclaimation and dranage projects. It was also not to engage in an operation, which was essentially for refunding or refinancing.

The I.F.C. invests in association with either local or foreign private investors or both. It does not invest in Government owned undertakings or in the management of which Government participates to any significant extent. But it provides finance to the enterprise essentially private in character, despite the Government investment. Before making an investment in a country which restricts or regulates payments or obligations in foreign exchange the I.F.C. would like to enter into an understanding with the Government, like any other private investor, regarding transfer of income and return of capital of its own investment. But it does not seek preferential treatment which is not available to private investors engaged in the same type of transaction.

In the initial stages of its operations, the Corporation proposes normally to entertain investment proposals where (a) the total

investment in the enterprise is a minimum of about U.S. \$ 50,000 or its equivalent; (b) the participation sought from I.F.C. is at least U.S. \$ 100,000 or its equivalent. Generally the Corporation will not invest more than about \$ 2 million in an enterprise.

The I.F.C. is now authorised to invest in capital shares. Firstly, it has been able to simplify the methods of its investments considerably and to offer its support to industrial projects in the form of straight equity or in a combination of loan and equity. It can suit its assistance to whatever is appropriate in each particular case. It need no longer complicate matters by offering finance of a kind unfamiliar in many countries and often difficult for entrepreneurs and co-investors to accept. It will play a great role in developing capital markets. Its reserves are modest, but their effect can be considerably enhanced, if they can be used in a way that can mobilise other resources. It has done underwriting business and it has further encouraged investors by taking a stand-by position in regard to issue both of shares and debentures, which may be converted into shares. The I.F.C. is developing loan companies and providing their capital also. For instance, the National Bank for Economic Development in Morocco and the Private Development Corporation in the Philippines have been formed through the Corporation's assistance.

The Corporation has the authority to invest in any kind of productive private enterprise, including agriculture, financial and commercial undertakings, but its main emphasis is on industry. It invests its funds only when it is fully satisfied that the private interests concerned are contributing their full share of the funds required and that the requirements cannot be met on reasonable terms from elsewhere. 'The most important thing is that it is to supplement and not take the place of private investment.[16] Though the I.F.C. enjoys all

16/ I.B.R.D., Annual Report, 1954-55

the privileges normally accorded to an international organisation, but as far as the application of the foreign exchange regulations on the transfer of earnings and of repayments of principal on its operational investments is concerned, it is to be in the same position as private investors generally are.[17]

The I.F.C. charter gives it greater latitude than possessed by the Bank in financing private enterprise. The Bank may lend to private borrowers only with the Government guarantee. This has tended to deter private enterpreneurs from seeking Bank finance and even when they have been willing to do so, the Government concerned have frequently been unwilling to pledge their credit in favour of particular private enterprise. Second, the Bank makes only fixed interest loans, whereas, the principal need of a new or expanding enterprise is often for venture capital.[18]

The I.F.C. keeps its financial assistance on a revolving basis. This is to say that after the enterprise to which a loan has been given or in whose share capital I.F.C. has participated has reached a stage of maturity, it sells its bonds or shares to other private investors. The capital thus withdrawn is available for assistance to other needy and eligible enterprises. This revolving basis of the funds serves two purposes : First, the I.F.C. provides initial loan capital or part of the share capital. Second, by the sale of its bonds or shares, it stimulates participation of foreign private capital in the private sector of the economies of underdeveloped countries. Thus the I.F.C. performs the dynamic function of acting as a catalytic agent. But the very fact that the I.F.C. does not require a guarantee of the local Government makes it obligatory on it to apply strict banker's tests to the loans or the share capital which it provides.

17/ Ibid

18/ Ibid

The I.F.C. charges a high rate of interest of about 7 per cent, and also insists on additional payments contingent on profits as well as option on shares, thus ensuring for itself the benefits accruing to a fixed rate lender as also of an equity holder. "In many cases industrial borrowers in the developing countries who have contacted the I.F.C. in the first instance, were later on able to secure external credits at more favourable terms from private institutions. A review of the working of the I.F.C. shows that while it is operating from funds provided by Governments, in essence, it is working like any other commercial agency, which would like to derive the maximum benefit from the existing conditions in the international capital markets."19/

The Indian Industrial Delegation led by Sri G.D.Birla in September-November 1957 found the attitude of I.F.C. 'rigid' and its interest rate 'so exorbitant that we need not expect much from this quarter'. Further, if the progress of the I.F.C.'s operations continues at the present rate, the capital of the Corporation alone will be in a position to finance its investment commitments for the next two decades or more since only $ 3.4 million could be disbursed in first ~~xx~~ two years or more.

The I.F.C. or any other organisation can encourage the flow of foreign investments in underdeveloped countries only by making successful investments on terms which do not place it in a more favourable position than other investors in the undertaking in regard to the risks undertaken and returns ensured, both taken together. It may be that a few enterprises may agree to accord to the investments of the I.F.C. a more favourable treatment than to other investors in view of the peculiar problems of such enterprises or of the countries in which they may be located. But this discriminatory treatment can last only for

19/ International Businessmen's Conference, Karanchi, December 1960, Document IBC/113 : P.3. Also see Report of Industrial Delegation to The Federation of Indian Chambers of Commerce and Industry September-November, 1957.

a short duration and the long term flow of foreign capital can only be encouraged on the basis of the equality of foreign and domestic capital.

The International Development Association

I.D.A. is an affiliate to the World Bank, which came into existence in September 1960 to supplement the financial assistance provided by the Bank.[20] It is to promote economic development, increase productivity and thus raise standards of living in the less developed areas of the world.[21] The primary purpose underlying the establishment of I.D.A. was the creation of a supplementary source of developmental capital for countries whose balance of payments prospects would not justify their incurring, or continuing to incur, external debt entirely on conventional terms. The financial terms attaching to I.D.A. credits have, therefore, been designed with due regard to this purpose. An effort is being made, however, to assure wide geographical distribution of development credits, taking into account the priority which should be given to the poorer countries. At the same time, probably it will be necessary to observe a limit on credits for some countries which could quickly present enough suitable projects to absorb a disproportionate amount of I.D.A. Funds.

The following table shows the amount of development credits extended by I.D.A. to its member countries.

Table No.59

Statement of I.D.A.'s Development Credits June 30, 1962.[22]

(In U.S. Dollars)

Member in whose territories development credits have been made.	Effective development credits held by Association: Disbursed portion	Effective development credits held by Association: Undisbursed portion	Effective development credits held by Association: Total	Development credits not yet effective
1	2	3	4	5
Chile	-	19,000,000	19,000,000	-
China	800,968	14,499,032	15,300,000	-
Colombia	2,407,934	17,092,066	19,500,000	-

20/ Gautam, R.K. 'The International Development Association, Banker-Delhi; October, 1960.

21/ IDA., First Annual, Report 1960-61 : P.3

22/ I.D.A., Second Annual Report, 1961-62, P.23 Appendix 'D'

1	2	3	4	5
Costa Rica	35,010	5,475,000	5,500,000	-
Honduras	611,003	8,200,927	9,000,000	-
India	6,637,345	61,832,155	60,500,000	22,500,000
Jordan	-	2,000,000	2,000,000	-
Pakistan	-	-	-	21,000,000
Paraguay	-	-	-	8,000,000
Sudan	921,570	12,075,430	12,000,000	-
United Kingdom, Swaziland	734,156	3,035,844	7,000,000	-
TOTAL	12,168,476	152,481,574	174,000,000	60,500,000

The main features of the development loans provided by the Association so far are : Firstly, all development credits have been made to member countries or to the government of a territory of a member. Secondly, after undisbursed balance the Association has entered into irrevocable commitments to disburse $ 1,115,916. Finally, agreements providing for these development credits have been signed, but the development credits do not become effective and disbursements thereunder do not start until the borrower takes certain action and furnishes certain documents to the Association.

I.D.A. has begun its work at an opportune time in the era of economic growth and political change which has followed the way the demand for development capital has markedly expanded. In a growing number of developing countries, however, the need for, and the ability to make effective use of, outside capital is increasing faster than the ability to service conventional loans,; some countries have already begun to draw close to the limit of the debt they can prudently assume on conventional terms. The problem is compounded by the circumstances of many newly independent countries. They are not able to rely to the ~~xxxx~~ same extent as before on the financial support of the metropolitan powers, including guarantees on loans floated abroad; but they have not yet developed a credit standing of their own sufficient to enable them to borrow on the scale they require. Hence the principal justification

for such an organization is the extent to which it supplements the facilities provided by the existing international financial institutions.

The Association's main purpose is to assist economic development in relatively underdeveloped countries: the advanced nations should therefore contribute more towards its funds so that it may be in a position to grant loans on especially favourable terms, loans with a long running period, a relatively extended period of grace and at low interest rates. In advancing loans, the need of the country together with the monetary and financial stability should be the main guiding principle and not the proportion of contribution made by the underdeveloped countries towards its funds. Upto June 30,1962, out of the total loans of U.S. $ 174,600,000 only 1.6 per cent, has gone to U.S.A. and Swaziland, ~~xxx~~ but the remainder has gone to the underdeveloped countries.

The I.D.A. should provide for the amortization and servicing of development loans in soft currencies. These are projects, which while technically and economically sound, may yet fall short of the criterion of the World Bank in regard to the repayment in hard currencies. Again, the Association should also finance local currency expenditures on essential development projects so as to avoid undue emphasis on the balance of payments aspects of development programmes.

It is also desirable that the Association should have in mind the social conditions of the people in the underdeveloped countries, carrying the benefits of its operations to those plans and works, which due to their particular nature, do not find sufficient economic support at present. In some cases it would be proper for it to consider financing pilot projects in some fields of social overheads of a type which are not financed by the Bank.

The Association should keep the closest working relationships with representatives of the underdeveloped countries so as to ensure

that its efforts will be directed to meeting the most important developmental needs in the best possible ways. Its aim should be to increase the total flow of development capital to the underdeveloped areas and not as a substitute for the bilateral assistance from the industrial countries.

Conclusion

The way the whole range of development problems of the underdeveloped countries are now evolving is extremely complex and the international institutions are only beginning to find the answers to them. Efforts should be made to make the fullest possible advantage of the strong ~~xky~~ financial position in which the I.B.R.D. and its affiliates now find themselves. They should not hoard their strength, but they should use it.

The Bank has now not only ample reason, but ample strength and ample experience to modify the terms of its lending in appropriate cases so that they will be more suitable for the new kinds of clients and the new kinds of projects. In particular instances, the grace period may need to be lengthened to allow the projects financed to be brought into full earning power or to give a longer breathing spell to a borrower whose repayment capacity may take some years to build up. And it would be equally reasonable, in given instances, to lengthen the maturity of Bank loans, which upto now have generally had a maximum life of 25 years.

But it should not be forgotten that Bank's efforts are only a small part of the picture. If the tempo of development is really to be quickened, it will call for increased determination and more effective action by national governments, governments of both the industrialised and the less developed nations.

Each year a little more of the growing strength of the capital exporting countries should be put at the disposal of the developing world. The flow of development assistance now comes from more sources than ever before; it needs to be better coordinated than in the past.

Over the recent past, the amount of assistance has risen considerably. This aid needs to be continued on an increasing scale. Equally important, the terms on which it is provided, although now somewhat better than in the past, still need to be improved. The efforts of the Bank and its affiliates to alleviate the problems posed by the debt structures of less developed members will be of little avail unless bilateral aid is more generally available on terms which satisfy the recipient's legitimate needs.

In addition to finance on sound terms, the developing world requires from the industrialized nations not only increasing aid, but also easier access to their markets. The primary products of many underdeveloped countries to-day encounter trade obstacles, be they tariffs, quotas, or internal taxes. Trade restrictions are also a serious barrier to the efforts of the developing countries to industrialize and diversify their export structures - tasks which indeed would be inherently difficult enough even with free access to markets. It is, therefore, high time for the developed countries to re-examine their trade policies vis-a-vis those less developed. The outcome of that re-examination will be of the greatest significance.

Proper resource utilization - (policy problem) - in the developing countries is another matter of great concern. The main difficulty arises at the time of project preparation and its execution. The length of time which is generally necessary for Bank's borrowers to prepare a project and make it ready for financing is much less than what is taken by the underdeveloped countries. Moreover, even on projects already approved, the rate of disbursement is often slow, and it seems x recently to have become even slower.[23]

23/ Read address by George D. Woods, President of the World Bank, IFC and IDA in I.M.F. Financial News Survey, Vol. XV, No. 39, October 4, 1963, P. 341

This is a matter which needs thorough investigation as the less developed countries cannot afford project delays. If the trouble lies with the procedure of the Bank, it should be improved and efforts should be made to help its borrowers to remove bottlenecks. But it should not be forgotten that no assistance from outside can be effective, unless the borrowing government is itself committed to speeding up project work by simplifying administrative and other practices and by giving it appropriate priority in the allocation of scarce personnel resources. When the project delays are due to shortage of local funds needed to supplement the foreign investment, there is little sense in borrowing external resources.

Financial and technical assistance from the Bank and other public sources is never going to be more than marginal to the requirements of the developing countries. While the Bank can lubricate the machinery, the chief driving power must come from elsewhere. most of all from the developing countries themselves. But there is one source in particular of which much more use can be made and that consists in the energies, the talents, and the capital that exist in the private sectors of both the developed and the underdeveloped countries. The Bank and its affiliates have only an obligation to do all they can to create the conditions which will unlock this resource. With this objective in view it should provide facilities under the umbrella of the Bank for conciliation and arbitration of international investment disputes.

The Bank, as a non-political international organisation, must accept with reservation the decision arrived at amongst its sovereign member nations regarding the import of foreign private capital for

accelerating their developmental efforts. To a great extent the attitudes of many of the less developed countries toward foreign private investment are based on the outdated past rather than on present facts. Those countries who adopt as their national policy a welcome for international investment giving foreign investor a fair opportunity to make attractive profits - will achieve their development objectives more rapidly than those who do not. For a country which is known to be hospitable to private investment will have access over the years to a much larger and much more stable pool of capital than its neighbour which relies solely on government - to - government aid. It will have access, too, to a much larger pool of industrial personnel - managerial, administrative, and technical - and to a much larger mass of scientific and technological information than it could possibly acquire in any other way. Most important of all, its economy will be stimulated and invigorated by the many different contacts, at many different levels, which a hospitable investment climate will make possible between enterprises and individuals within its own borders and those within the borders of the industrialized countries. None of these advantages is likely to be fully available to any nation whose government, however, well motivated and, however, well administered, decides to relegale the private sector to a subordinate role. In this respect the Bank and its affiliates should advance to new plateaus of usefulness to the peoples of their member countries.

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CHAPTER VIII

FINANCES FOR INDIAN ECONOMIC GROWTH

In this chapter we propose to review critically the financial aspects of economic growth in our country during the period of quinquennial economic plans.

The First Plan attempted a long-term projection of economic growth and its emphasis was essentially on infrastructure investment in agriculture, transport, power, etc. It attempted only a modest programme of industrialization. For instance, the expenditure on agriculture, community development and irrigation in the First Plan was of the order of Rs. 861 crores out of an outlay of Rs. 1,960 crores in the public sector. Expressed as a proportion of the total outlay, it works out at 44 per cent, while on industries, the expenditure was 6 per cent. The national income of the country increased by 18 per cent, while prices declined by over 17 per cent during the plan period. On external account, the Plan imposed no strain on the economy. The utilisation of the sterling balances represented mainly the effect of capital transactions. The overall investment during the First Plan was of the order of about Rs. 3,300 crores, both in the public and the private sectors, of which the respective shares of the public and private sectors were 52 per cent and 48 per cent respectively.

The Second Plan laid special emphasis on basic industries like steel, coal, and transport. The total investment envisaged was Rs. 3,800 crores in the public sector and another Rs. 1,000 crores as current outlay and Rs. 2,400 crores in the private sector. Our international reserves were rapidly depleted. Rs. 200 crores were envisaged to be utilised over the entire Plan period, but in the first half of the Plan period, the utilization was of the order of Rs. 600 crores. Domestically, the investment caused a great strain on available resources. It was,

therefore, decided to cut down the public sector outlay in November 1958 from Rs. 4,800 crores to Rs. 4,500 crores. A much larger volume of external assistance than had originally been planned was obtained through the Consortium sponsored by the International Bank For Reconstruction And Development. The public sector outlay was of the order of Rs. 4,600 crores, of which Rs. 3,650 crores represented investment outlay, while private investment was of the order of Rs. 3,100 crores.

The pattern of financing, as realised, differed considerably from the original programme as envisaged for the public sector. The additional taxation measures produced about Rs. 1,000 crores as against an estimate of Rs. 400 crores. The surplus expected from tax earnings at current rates did not materialise. Small savings at Rs. 393 crores fell short of the target of Rs. 500 crores, the annual target having been slightly exceeded in the last year of the Plan. Surpluses from public enterprises did not come up to expectations. The rise in price level together with a shortfall in domestic resources in the earlier years of the Plan led to a larger recourse to deficit financing than was originally anticipated. A substantial part of the expenditure obtained through deficit financing was incurred abroad on capital equipment and was thus not inflationary. The expansionary influence of the primary credit creation did take place. The effects of the deficit were mitigated through private imports financed by the utilization of our international reserves.

Real income over the Plan period went up by over 20 per cent as against a 33 per cent rise in money supply. It should, however, be noticed that the variance between the rates of monetary expansion and income growths declined towards the end of the Plan period. Over the entire period of the first ten years of planning, national income rose by 42 per cent, but giving allowance for growth in population, the increase in *per capita* income was only 17 per cent. Agricultural

production rose by over 41 per cent, while industrial output was nearly doubled.

Taking the ten year period as a whole, the degree of balance between the growth of real national income and monetary expansion is remarkable. As against a rise of 42 per cent in national income, the money supply rose from Rs. 1,848 crores in 1951-52 to Rs. 2,868 crores in 1961-62, which means a rise of 55 per cent.1/

The Third Plan

The Third Plan envisaged an increase of 5 per cent per annum of national income, self-sufficiency in foodgrains, expansion of basic industries and of employment opportunities and the progressive establishment of greater equality of opportunity and of incomes and a more even distribution of economic power. The annual rate of income growth envisaged in the Third Plan is more than the average achievement over the first two Plan periods. The targets for income growth are based on anticipations regarding the level of investment in relation to income and the ratio of investment to increments in income. The pattern of growth over time and over different sectors is set by regulating investment in volume and over different sectors of economy. The rate of net investment was expected to rise from 11 per cent of national income at the end of the Second Plan to 14 - 15 per cent of national income at the end of the Third Plan. The ratio of domestic saving to income was expected to rise from 8.5 per cent to 11.5 per cent during the period. The forecasts of the growth of income also depend on the expected behaviour of capital/output ratios. ~~Th~~ The expected capital/output ratio in the First Plan was 3 : 1, but it worked out at 2.1 : 1. This favourable turn was due to an increase in agricultural output and the fuller utilization of existing industrial capacity. The capital/output

1/ Mr. Narasimham puts the rise in money supply at 47 per cent vide p. 384, I.M.F. Staff Papers; Vol. IX, No.3, November, 1962

ratio for the Second Plan was anticipated to be 2.3:1, but it worked out at 3:1. This was due to setback in agricultural production and the greater concentration on projects with a long gestation period. The Third Plan postulates a capital output ratio of 2.3:1. It is interesting to note that this method is adopted in other countries also, but naturally the actual achievement would vary from country to country, depending upon differences in economy. The following table shows the capital/output ratio in some of the underdeveloped countries.

Table No.60

Rate of Increase of Investment and Incremental Capital/Output Ratio in Current Plans. 2/

Country	Plan Period			Incremental net Capital/Output ratio	Net Investment as per cent of national product
Burma	1961/62	-	1964/65	2.5	14.8
Cambodia	1959	-	1964	3.0	15.0
Ceylon	1959	-	1968	2.6	15.3
China : Taiwan	1957	-	1960	2.1	15.8
Fed.of Malaya	1961	-	1965	3.9	16.1
India	1961/62	-	1965/66	2.2	13.0
Indonesia	1956	-	1960	2.8	8.5
Iran	1955/56	-	1961/62	3.0	18.0
Japan	1961	-	1970	4.3	31.0
Philippines	1959/60	-	1961/62	2.1	12.5
Pakistan	1960-61	-	1964/65	3.6	13.4
Thailand	1961	-	1966	2.5	15.0

According to the above table, Burma, Ceylon, China : Taiwan, Philippines and Thailand have a more favourable capital/output ratio than India. But the circumstances vary from country to country. In the current Plans of the countries of South East Asia, the capital/output ratio varies rather widely from 2 to 4.

Caution must be exercised in the use and as regards the reliability of the capital/output ratio. 3/ For industrialised countries, the capital/output ratio remains stable over longer periods than in underdeveloped economies, where agriculture is dominant. The capital output ratio estimated at 2.3 in India's First Plan was actually 1.8 due

2/ ECAFE Bulletin, Vol.XII,No.3,Table No.2,P.5,December 1961.
3/ Ibid, P.4,November 1955.

to favourable weather. Better use of idle capacity may yield a lower capital/output ratio as in Ceylon and India in the early post-war years. Secondly, the capital/output ratio includes physical capital, but in the development outlays in the plans, investment expenditure on human capital is also included and it is not possible to judge its quantitative effects on output. Thirdly, in underdeveloped countries statistics bearing on capital formation and national income are rough and the time lag between investment and output is assumed arbitrarily with the result that the ratio thus arrived at tends to be unreliable, specially when the time series is short.

Owing to the shortcomings, the capital requirement arrived at cannot by itself be relied upon. It may, however, be pointed out that in spite of the variation in the planned rate of growth in the national income and in the capital/output ratio, the rate of investment in the current plans of the majority of the countries shows amazing similarities. It is around 13 to 16 per cent of the national product, notable exceptions being Japan on the high side at 31 per cent and Indonesia on the low side at 8.5 per cent.

Financing of the Plan

The total investment expenditure of the Third Plan comes to Rs. 10,400 crores, of which Rs. 6,300 crores represent public sector expenditure and the remainder private investment. A sum of Rs. 1,200 crores in the public expenditure is to be added as current outlay. The total resources thus work out as Rs. 11,600 crores. The external assistance was envisaged at Rs. 2,100 crores. Domestic savings were thus to account for Rs. 8,300 crores. The Plan recognises that it would be difficult to estimate precisely the extent to which the different programmes could be fulfilled. There might also be an element of elasticity on the side of the resources. According to the Plan, resources are not a fixed fund to be drawn upon; they depend partly on the scale of

investment being undertaken and the resulting increases in output during the Plan period.[4]

Financial Resources for the Public Sector

The following table gives the financial resources for the public sector of the Third Plan.

Table No.61 [5]

Estimates for the Second and the Third Plans

Item	Rupees in Crores		
	As initially estimated	As estimated now	Third Plan
1. Balance from current revenues (excluding additional taxation)	350	-50	550
2. Contribution of Railways	150	150	100
3. Surpluses of other public enterprises	-	-	450
4. Loans from the public (net)	700	780	800
5. Small savings (net)	500	400	600
6. Provident Funds (net)	250	170	265
7. Steel Equalisation Fund (net)		38	105
8. Balance of miscellaneous capital receipts under non-Plan disbursements		22	170
9. Total of 1 to 8	1950	1510	3040
10. Additional Taxation including measures to increase the surpluses of public enterprises	450	1052	1710
11. Budgetary receipts corresponding to external assistance	800	1090	2200
12. Deficit Financing	1200	948	550
TOTAL	4800	4600	7500

Of the total of Rs.7,500 crores for the public sector in the Third Five Year Plan, Rs.4,750 crores or 63 per cent represents domestic resources, Rs.550 crores or 7 per cent deficit financing and Rs.2,200 crores or 30 per cent external assistance.

The resources of the centre and the states for the Third Plan are given below.

4/ Third Five Year Plan : Government of India-Planning Commission P.93.

5/ Ibid : Table 2, P.95

Table No.62

Resources for the Third Plan [6/]

Item	Rupees in Crores Centre	States	Total
1. Balance from current revenues (excluding additional taxation)	410	140	550
2. Contribution of Railways	100	-	100
3. Surpluses of other public enterprises	300	150	450
4. Loans from the public (net)	475	325	800
5. Small Savings (net)	213	387	600
6. Provident Funds (net)	183	82	265
7. Steel equalisation fund (net)	105	-	105
8. Balance of miscellaneous capital receipts over non-plan disbursements	428	-258	170
9. Total of 1 to 8	2,214	826	3,040
10. Additional taxation including measures to increase the surpluses of public enterprises	1,100	610	1,710
11. Budgetary receipts corresponding to external assistance	2,200	-	2,200
12. Deficit financing	524	26	550
TOTAL	6,038	1,462	7,500

The Third Plan envisaged to secure Rs.550 crores from the balance of current revenues at existing tax rates. The estimate of surpluses from revenues was based on certain assumptions regarding the growth of tax yield with an increase in economic activity. Naturally, the tax receipts would vary from year to year with variations in the growth rates in the economy. With improvement in tax administration evasion could be reduced, which would help to raise the amount of envisaged revenue. The Second Plan outcome from this source of finance was markedly different. As against an initial estimate of Rs.350 crores, at the rates of taxation prevailing at the beginning of the Plan there was at the end of the Plan a deficit of Rs. 50 crores. This indicated a deficit even for current expenditure. The yield from additional taxation was, however, much higher than anticipated. The substantial increase in the expected balance from revenues during the Third Plan, as compared with the Second Plan, is due to two factors : (i) an increase in economic activity during the last few years and (ii) imposition of additional taxation in the Second Plan period.

6/ Ibid : P.100, Table 3

According to the mid-term appraisal, States have been experiencing difficulties in raising resources on the scale postulated in the Plan. Additional taxation undertaken in them has been lower than the targets. According to the Commission, in some of the states it would be difficult to implement the original Plan in full without further steps to strengthen their financial position.

During the first three years of the Plan, normal tax receipts both at the centre and in the states are better than earlier estimates. If present trends continue, the total tax receipts over the Plan period at 1960-61 rates of taxation would exceed the earlier estimates by about Rs. 800 crores.

As against the original target of Rs. 1,000 crores of additional x taxation, the aggregate yield over the Plan period from the taxation measures introduced till March 1963 at the Centre may exceed Rs. 1,900 crores. Taking both the Centre and the states together, additional taxation measures would yield over the Plan period about Rs. 2,400 crores or Rs. 700 crores more than the target.

The improvement in tax yields would, however, be offset by the deterioration under the item 'balance from current revenues'. This is because of the step up in defence outlays and inevitable increases under other non-Plan expenditures.

According to the appraisal of the Plan, in terms of national income growths, the achievements in the first two years of the Third Plan have been less than anticipated. The rise in annual income is estimated to have been about 2.5 per cent as against over 5 per cent as envisaged in the Plan.

The Commission estimates that over the five year period as a whole the total outlay in the public sector, subject to availability of resources might be about Rs.8,000 crores as against the original estimates of Rs.7,500 crores.

Contribution from the Railways

The railways were expected to contribute about Rs.100 crores. This represents the surpluses of expected current earnings of the railways over their expenses, excluding investment expenditure. But after providing for depreciation and the payment of interest and dividend, the contribution in the Second Plan came to Rs.150 crores. This included receipts from increases in fares and freights. The surpluses of Rs. 100 crores in the Third Plan do not include additional resources that can be raised by a rise in fares and freights. The following table shows the railway surpluses.

Table No. 63/

Railway Surpluses

Year	Surpluses in crores of rupees
1961-62	24.40
1962-63 (R.B.)	23.20
(1963-64(B)	31.00

This means that the annual railway surpluses exceed Rs. 20 crores and in three years the railways have been able to raise Rs. 17 crores more than the average anticipated in the Third Plan.

Surpluses of other Public Enterprises

The surpluses from other public enterprises after meeting their annual normal expenses are put at Rs.450 crores. It may be pointed out that in the Second Plan period the contributions from the public enterprises were shown under balance from current revenues and additional taxation. This amount of Rs.450 crores includes Rs. 300 crores from the Central Government enterprises and the remainder from the enterprises of the state governments. Of the enterprises at the Centre, the steel plants are expected to make the major contributions, while in the states electricity undertakings may contribute sizeable sums.

Much will depend on the fact that industrial units reach their targets in time, work with efficiency and follow suitable price policies.

There are conflicting considerations of stepping up their yields to mobilise resources and of keeping the prices of goods like fertilisers low in the interest of the consumer.

The public enterprises ought to earn reasonable profits if two conditions are satisfied : Firstly, the low profit yielding enterprises improve in their profitability, and secondly, important enterprises in gestation come up to their targets. The public sector then should compare with the rest of the economy in ploughing back profits.7/

Small Savings

The amount under small savings in the Third Plan period has been placed at Rs. 600 crores, of which, the Centre is to account for Rs. 213 crores and the states for Rs. 387 crores. The average works out at Rs. 125 crores. The amount under small savings net remained much below the annual target of Rs. 100 crores. This is indicated in the following table.

Table No.34

Trend of Small Savings in India 8/

Year	Crores of Rs.	Year	Crores of Rs.
1950-51(accounts)	32.52	1959-60(accounts)	82.91
1955-56(accounts)	66.51	1960-61(accounts)	103.77
1956-57(accounts)	58.95	1961-62(accounts)	87.75
1957-58(accounts)	69.46	1962-63(Budget)	105.00
1958-59(accounts)	78.21	1962-63(Revised)	85.00
		1963-64(Budget)	105.00

Thus in the Second Plan period except during the last year small savings lagged behind the estimates of the Plan Document. The performance in the Third Plan is better, particularly in 1962-63, but on the whole the actuals are behind the annual targets of Rs.125 crores. The potentialities in our country are large and growing, particularly because of a rise in income in the lower and middle income brackets.

7/ Read the 'Finances of Public Enterprises' V.V. Ramanadham, Chapter I, 1962, Under the auspices of the Indian Institute of Public Administration, New Delhi.

8/ Report on Currency and Finance for 1962-63, statement 50, P. 94

Savings drive should be extended to rural areas, which offer great scope.

Loans and Funds

Public loans were to contribute Rs. 800 crores, or Rs.160 crores per annum. This target cannot be compared with the collections in the Second Plan of Rs.780 crores under market loans. They included purchases by the Reserve Bank and the investment by the State Bank of P.L.480 counterpart Fund Deposits in Government securities. Such investments are not included in the Third Plan targets. The Third Plan estimate envisages a great increase in the purchase of securities by the L.I.C., the non-governmental provident funds and other investors. Commercial banks will also absorb loans. Under the Second Plan on this basis only about Rs. 300 crores were raised. During the Third Plan period, repayment of the maturing debt will be of the order of Rs. 980 crores. The private sector will also compete in the capital market. According to the appraisal of the Third Plan, so far as market loans and provident funds are concerned, the actual realisation over the Plan period is likely to be somewhat better.

The efforts of the L.I.C., the increase in the number of industries providing provident fund benefit should indicate better yields. The extent to which banks take up Government securities would depend upon the growth of their deposits and the increase in demand for credit. On the whole, the performance of market loans should come up to expectation.

Steel Equalisation Fund and Other Capital Receipts

Steel Equalisation Fund receipts come out of the surcharges on steel. This contribution of Rs. 105 crores will depend upon the achievement of the target of steel production. Miscellaneous capital receipts are expected to produce Rs. 170 crores. Betterment levies are also included in them. The experience of the Second Plan with betterment levies is not encouraging. Other miscellaneous capital receipts include recoveries of loans and advances from local bodies and

inflows on account of deposits and remittances. Expenditures include compensation payments to refugees and zamindars and loans and advances to cultivators. Non-Plan capital disbursements should be kept at a minimum.

Deficit Financing

Deficit financing was to be limited to Rs. 550 crores in the Third Plan, which is about 7 per cent of the total resources required for the public sector. It is about 40 per cent of that in the Second Plan and about 15 per cent more than in the First Plan in absolute amount. The aggregate expenditure in the Third Plan is equal to that in both the earlier Plans put together. From another point of view, it is about 22 per cent of the revenue expenditure of the Government of India for 1964-65. The amount of deficit financing should be considered in the context of the monetary needs of the economy. Actually in the Third Plan so far in three years, the national income has expanded by 2.5 per cent per annum as against the estimated increase of over 5 per cent per annum. The economy is becoming increasingly monetised and the community is having a tendency to hold larger cash balances. This means, that income velocity will decline somewhat. The private sector will also require credit from the Reserve Bank. The total monetary expansion during the Third Plan period will be about 35 per cent. The Plan document emphasises that there is "no precise way of estimating the limits of safe deficit financing".9/ This appears to be compatible with monetary stability. The limit ~~xxx~~ to deficit financing is also set by the absence of a foreign exchange cushion.

The following table shows the amount of deficit financing during the Third Plan period.

9/ Third Five Year Plan of India : P.99

Table No.65

Deficit Financing in the Third Plan 10/

Year	Crores of rupees
1961-62	115
1962-63	156
1963-64(B)	181
1963-64(R)	153
1964-65(BE)	86

The overall deficit for the Plan period as a whole is likely to be larger than Rs. 550 crores and efforts must be made to see that it should be within safe limits.

Investments for the Private Sector

Total investment in the private sector in the first ten years came to Rs.4,900 crores, of which investment in organised industries, mining and small industries came to about 28 per cent or Rs.1,400 crores. A major part of the resources for development of private industries was provided from the internal resources. 62 per cent of the total investment in the First Plan and 47 percent in the Second Plan came out of undistributed profits and surpluses. During the Third Plan the investment in the private sector was estimated at Rs.4,300 crores. The internal resources of industry will contribute about 48 per cent. For the organised industrial and mining programme, capital requirements will come to about Rs. 1,400 crores. The sources of supply for industries are a.

Table No.66

Sources of Supply

Sources	Rupees in Crores
Institutional	Rs.80 crores
Direct loan participation by Government	Rs.20 crores
Foreign Capital	Rs.200 crores
New Issues	Rs.150 crores
Internal sources	Rs.400 crores

10/ These figures are based on the budget speech of the finance. Minister published in the Hindustan Times. According to the mid-term appraisal, published by the Planning Commission of the Govt.of India Nov.1963 in 1961-62 and 62-63, deficit financing accounted for Rs.168 and Rs.171 crores respectively while budget estimates for 63-64 put this figure at Rs.241 crores.

External Resources

The requirements for the external assistance for the Third Plan came to Rs.2,600 crores, including refinancing of maturing obligations of Rs.500 crores. The foreign exchange content for the public sector was put at Rs. 1,520 crores and for the private sector at Rs. 1,025 crores.

Taking into view the finance required for importing food grains from U.S.A. under P.L.480 amounting to Rs.600 crores, the balance of payments gap comes to Rs. 3,200 crores. The exports were put at Rs. 3,700 crores, external assistance at Rs.2,600 crores and deficit in capital transactions at Rs.550 crores so that the total of receipts for the Third Plan was put at Rs. 5,750 crores. Thus on account of exports the estimate of Rs.3,700 crores is the minimum. According to the Plan document what emerges on the whole is that the balance of payments position will continue under strain and that the external account will barely balance, even with exports of the order of Rs.3,700 crores.[11] This target of exports ~~af~~ is by no means easier of achievement. The average of exports in 1961-62 and 1962-63 is Rs. 674 crores with a slightly rising tendency. This, however, falls short of the average of Rs.740 crores. Since 1954, exports in Japan have expanded annually at 18 per cent. This rapid increase of exports of the country raised the import capacity.[12] Our exports must also be expanded at a faster rate than has so far been possible.

The average of imports estimated in India's Plan was Rs.965 crores, but the average for the first two years of the Third Plan period exceeds Rs.1100 crores. That means that either exports must be expedited or foreign assistance of a higher amount than envisaged in the Plan will be necessary. Any rise in import costs and a lag in export performance

11/ Third Five Year Plan of India, P.113

12/ The Bank of Japan its Functions and organisation, March 1962,P.2 The Bank of Japan, Economic Research Department.

is bound to upset the estimates. Our exports are growing slowly, but our import needs are growing rapidly. The difficulties in raising exports are obvious. According to the Plan document , the trends in exports should be kept under review at the highest level throughout the period of the Plan and all steps taken to ensure that export earnings are maximised......It will be essential in the coming years not only to restrain consumption in the interest of exports, but also to increase productivity and to keep down costs.13/

The following table shows the trends in the balance of payments position since the beginning of the Second Plan.

Table No.67

Foreign Trade of India 14/

(Rupees in Crores)

Year	Imports(-)	Exports (+)	Balance of trade
1956-57	902.9	619.6	-283.3
1957-58	1,036.4	635.1	-401.3
1958-59	903.6	572.6	-331.0
1959-60	961.5	639.7	-321.8
1960-61	1,122.5	642.1	-480.4
1961-62	1,093.6	660.6	-433.0
1962-63	1,121.0	688.1	-432.9

Special efforts have been made to promote exports. According to the mid-term appraisal of the Third Plan 'foreign exchange position in the last three years continued to be difficult, although commitments to the extent of Rs.2,100 crores are now in sight, additional non-project assistance needed over the next two years amounts to Rs.450 crores.' There has been an appreciable increase in the quantum of foreign assistance coupled with the softening of the terms and conditions on which it was granted.

During the first two years of the Third Plan period external assistance totalled Rs.1,076 crores, being higher in the second year at

13/ Third Five Year Plan of India, P.113
14/ Reserve Bank of India Bulletin, March 1964, P.388

Rs.652 crores, as against Rs. 425 crores in 1961-62. The total authorizations of foreign assistance up to March 1963 came to Rs.2,473 crores, while utilization was of the order of Rs.1,343 crores and the amount undisbursed stood at Rs.1,130 crores.15/

The Plan document further emphasises that it is not desirable to continue to rely on foreign aid to the extent it has been done in the past and that every effort should be made to reach a reasonable degree of self-reliance by the Fifth Plan.16/ To implement this decision, it must be ensured that the projects to be taken in hand are designed primarily to strengthen the balance of payments by increasing exports and replacing imports without at the same time involving an excessively large foreign exchange component. In this connection emphasis has to be given on two points. Firstly, whatever is taken in hand must be implemented with speed and efficiency, Secondly, it is necessary to ensure the observance of correct priorities in investment in the light of the basic objectives of a self-reliant economy.

Resume

The Third Plan requires a major domestic effort coupled with substantial external assistance. The total investment proposed in the Third Plan is more than was done in the first ten years. In real terms, the Third Plan is not proportionately larger than the Second Plan as the figures would suggest. At 1960-61 prices, the public sector outlay of Rs. 7,500 crores does not exceed by more than 25 per cent - the outlay of Rs. 4,800 crores originally proposed for the Second Plan. The realization of the targets would depend on the actual increases in investment and income. According to the appraisal of the Plan, national income in the first two years has gone up only by 2.5 per cent per annum as against the estimate of over 5 per cent. There has been a setback in agricultural

15/ Report on Currency and Finance, for 1962-63, P.105
16/ P.51, The Third Plan Mid-Term Appraisal.

output. Industrial production increased by 6.5 per cent and 8 per cent respectively in the first two years as against the anticipated average of 11 per cent. There has been no proportionate setback in investment. In fact, the public sector investment is likely to be of the order of Rs.8,000 crores as against the estimate of Rs.7,500 crores. There might be shortfalls in resources raised from public sector enterprises, and the yield from additional taxation would turn out to be better than anticipated. In the first two years of the Third Plan tax yields are likely to exceed 75 per cent of the total anticipated for five years.

The capacity to raise domestic resources to an adequate extent presupposes that the expected rise in output would take place under the conditions of monetary and price stability. The price level at the beginning of the Third Plan was 30 per cent higher than at the beginning of the Second Plan. A certain upward pressure in prices is implicit in development, but it is necessary to prevent a rise in the prices of essential commodities. According to the Plan document, in regulating prices, reliance will have to be placed on fiscal and monetary discipline. Fiscal policy is being directed at limiting consumption and at producing the necessary resources. Monetary policy will be operated with necessary flexibility. It has been characterised with the objective of restraining excessive credit expansion, but at the same time, meeting the genuine credit needs of the economy so that the credit may be diverted for the productive sectors. At the same time physical controls in special sectors have to be employed.

The role of price policy is important. The basic trend in prices has remained upward during the period. According to the Plan appraisal, the increase in general price index has been of the order of 7 per cent. This is not in itself unduly high, but the problem arises from the fact that this rise is superimposed on the increase that has

occurred in the Second Plan period and there have been great increases in prices of essential consumer articles. The rise of 12.7 per cent in food articles since April 1963 to September 1963 is a matter of continuing concern and there has been a further rise since then. Price increases due to policy decisions are instruments for enlarging the investible resources of the economy and enabling the priority industries to expand in the manner required. Such policy-oriented price increases must be distinguished from price rises, which are due to inadequates in supply or distribution arrangements. The former must be accepted as inevitable while the latter must be kept in check.

The external resources position would present problems. The entire investment import content of the Plan has to be financed by external assistance over and above the refinancing of external debt repayment. The process of economic development is bound to raise the level of imports both in the aggregate and as a proportion of national income. This is the experience of the planning period. The doubling of exports has been envisaged during the next ten years. But in the short run, a certain hump in the balance of payments cannot be avoided when external assistance becomes vital. External assistance, of course, must be put to proper use and it must augment production. The assistance given by the Consortium members proves the capacity of the country that foreign aid is being put to adequate use. We must encourage foreign equity capital in all reasonable manner of ways to reduce pressures.

Proposed Outlay for the Fourth Plan

Estimates are being prepared for the Fourth Plan. The Third Plan document envisaged a net investment of Rs. 17,000 crores over the Fourth Plan to produce the annual national income of Rs.25,000 crores at the end of the Plan. This estimate was based at 1960-61 prices, but the price level has risen thereafter.[17] The Perspective Planning Division

17/ Third Five Year Plan : P.28

of the Commission estimates the outlay of about Rs.20,000 crores. At the present rates of taxation the total available resources for the Fourth Plan are put at about Rs. 10,000 crores. At the existing estimates, the public sector can have an outlay of not more than Rs. 13,000 crores, of which Rs. 11,000 crores can be investment outlay and Rs. 2000 crores current outlay. Even this is likely to leave a gap of Rs. 3000 crores in resources, which will require additional taxation of the order of Rs. 600 crores per annum.

The resources of Rs. 10,000 crores are to be made up as below :

Table No. 68

		Rupees in crores
1. Balance from current revenues at 1964-65 rates of taxation		
(a) Centre	995	
(b) States	550	
		1545
2. Railway contribution on the basis of the 1964-65 fares and freights		360
3. Surpluses of Public Undertakings		
(a) Central	450	
(b) State	200	
		650
4. Borrowings from the Public		1600
5. Small Savings		900
6. External Assistance		2500
7. Other funds		425
8. Miscellaneous capital receipts		450
9. Deficit Financing		1100
TOTAL		9530

The level of internal resources naturally depends upon the rise in national income. The Plan document estimated that by the end of the Third Plan net investment as a proportion of national income may reach 15 per cent, at the end of the Fourth Plan 17 to 18 per cent and at the end of the Fifth Plan about 20 per cent. Much, therefore, would depend upon the rise in national income. This has not gone beyond 2.5 per cent per annum in the first three years of the Third Plan. To realise investment target even of Rs. 13,000 crores for the public sector,

a rise greater than 6 per cent net annual increase in national income must be envisaged. In other words, there must be a 30 per cent rise in national income in five years. This will require a capital/output ratio of 2.5:1 on the basis of the past achievement.

The Fourth Plan must pay increasing attention to the provision of employment opportunities and to the improvement in agricultural yield. It must lay emphasis on the building up of heavy and defence industries and it should reduce the concentration of economic power in the economy.

In the Third Plan, there has been a marked shift in emphasis on agriculture towards quick yielding schemes. Much of the earlier investment in industry and other sectors is now reaching the stage of output. The expected output in agriculture would depend on reasonable normal weather and that in industry would depend on the extent to which major bottlenecks arising out of shortages can be avoided. The shortage of power and transport has continued in the Third Plan, and the targets of steel and fertiliser products are behind schedule.

The problem on the investment side will depend on the ability of the economy to mobilise the resources, both internal and external. Delays in the steel programme might affect the volume of resources to be raised from public sector enterprises. But the experience with regard to resources from additional taxation might turn out to be better than anticipated as is suggested by the past experience of the three Plans. The ability to raise domestic resources in adequate amounts would imply that the expected rise in output would take place under conditions of monetary and price stability. In the first two and a half years of the Third Plan, the price level rose by over 7 per cent. This in itself is not high, but when account is taken of the fact that the Third Plan started with a price level nearly 30 per cent higher than at the beginning of the Second Plan, the price rise should be considered as high and any further

rise in prices would effectively come in the way of mobilising the resources. Hence the experience of the Third Plan stresses the importance of an appropriate price policy. The role of the price policy should also be conceived in relation to different targets of production. It is not possible to avoid some relative price movements. They are necessary to divert resources for the priority sectors. Fiscal measures can check domestic consumption of exportable items, where some selective price increases are permissible. In any case, the prices of essential consumer goods used by the masses must be kept in check. The prices of essential raw materials must also be kept under check.

The position of external resources must be kept under constant review. In the Third Plan, the foreign exchange requirements for project imports have been revised upwards. This has been due to the widening of the scope of some Plan programmes and also because of the inclusion of the new projects in the Plan, particularly in the field of power and transport, mainly to broaden the infrastructure for the implementation of the Plan. Development is a continuing processes and basic sector projects have a long gestation period. Advance action must, therefore, be taken on projects which would be continued in the Fourth Plan. Only then a smooth transition to the next Plan period can be provided. No projects should be included without detailed reports.

According to the Third Plan Mid-Term appraisal, the total foreign exchange commitments to be entered into during the Third Plan period for projects and programmes in the public and private sectors would be considerably larger than Rs. 2,030 crores, while actual payments to materialise in the Plan period would be significantly smaller so that 'given the availability of external assistance to enter into commitments on the scale required the carry over of the assistance from the Third Plan to the Fourth Plan would be much larger than the amount available

from the similar carry over from the Second to the Third Plan.

During the Third Plan period foreign exchange finance for commitments of a little over Rs. 2,100 crores is already in sight as below :

Table No.69

	Rupees in Crores
1. External assistance available for financing project requirements at the end of the Second Year of the Third Plan	1,470
2. Consortium commitments	301
3. Allocations for export earnings for project commitments	200
4. Private foreign investment	150
TOTAL	2,121

The total commitments to be entered into inclusive of the advance action for the Fourth Plan would be considerably larger. Our balance of payments position is already strained and the same is the case about our external reserves. It is, therefore, necessary that commitments for further projects and programmes should be made on the basis of additional project assistance being made available. Apart from our requirements, the amount of additional project assistance to be committed during the next Plan period should depend on the procedures of the aid giving countries and institutions. Only a small part of the commitments in the rest of the Third Plan period would materialise as actual commitments. It would be possible to proceed with the projects that need to be taken in hand, even without external commitments at this stage for covering their entire foreign exchange costs, if there is understanding regarding additional commitments of aid from time to time in accordance with the schedule of actual payments. In this connection, the point to be emphasized is that

the requirements of project assistance during the rest of the Third Plan period should be based essentially on an integrated view of the results to be achieved during the next at least five years. We have to ensure that we do not rely on foreign assistance to an unduly large extent. It implies cost and at times it leads to rackless expenditure. Caution must, therefore, be observed in this respect.

We should depend on the mobilization of the domestic resources. The actual amount to be mobilised as well as the way the resources are mobilised affects the economy considerably. Care has to be taken to ensure that the resources mobilised do not produce inflationary effects. Deficit financing should, therefore, be limited to a productive use so that it may create conditions where in future the quantum of deficit financing required would become less. At the same time, appropriate monetary and credit policy should be pursued to see that there is flexibility in the economy, and at the same time, resources are available for the priority sectors. Expenditure in the non-Plan sectors should be reduced to the minimum and the same should be the case with purely administrative expenditure. Only then will the needs of defence and development of our economy be met in an appropriate manner.

CHAPTER IX

CONCLUSION

During the 1950's Asian countries began to make strenuous efforts to break the economic stagnation that had long held their vast population in poverty. This marked a highly significant change from passive acceptance of low standards of living to a determination to raise them by creating conditions for economic growth.

With the emergence of political independence one of the most important problems of economic policy has been the realization and assurance of full employment. Further, the assurance of satisfactory economic growth with stability has also taken a prominent place in the test of economic objectives. For many, this has become the predominant goal. In the last decade, a few countries of Asia were able to record relatively high growth rates. Compared to 1950's Japan made a rapid progress. India, Burma, Ceylon, Indonesia, and Pakistan recorded average results, while the growth rates of Nepal, Cambodia, Viet-Nam, Laos, China-Taiwan, Malaya, Singapore, Borneo and Sarawak have been considerably low.

Acceleration of development or the maintenance of a high rate of economic progress calls for encouragement of the flow of resources to development uses and their utilization in the most productive directions. These resources can come only from that part of total domestic ~~ax~~ output which is not consumed or from foreign borrowings. A development policy should, therefore, be judged by its influence on output, the rate of saving, the decisions of foreign lenders and the uses to which the total flow of investment funds are put. The future level of the output will be largely determined by current and foreign borrowing and by the productivity of the investment financed from these sources.

In many of the developing countries incomes are rising at a low rate. In them, low personal savings permit only limited resources to be released for the expansion of the community's capital and the tax systems provide only enough revenue to meet a part of the community's desires for Government services, with very little surpluses available to finance development.

Hence the recent literature on the problems of economic growth has assigned a central role to capital formation. Attempts at 'development programming' place considerable emphasis on measures designed to raise the rate of capital formation and to exert some guidance over the channelling of investment resources into what is believed to be their most productive uses. Though this latter objective has been recognized to be of paramount significance in the process of growth, surprisingly little attention has been devoted to what may be one of its more important aspects. The less developed countries to-day are more vulnerable to inflationary pressures than their now more developed counterparts were in their early stages of development. This being so, the possibility that inflation may influence the composition of investment in a way deterimental to development makes inflation specially significant to developing countries.

Inflation or the expectation of inflation is generally accompanied by three major factors that have a bearing on the composition of investment[1/]; (1) a magnification of the illiquidity risk; (2) uncertainty; and (3) a changing spectrum of profit opportunities arising mainly out of measures taken to correct the symptoms of inflation.

Liquidity preference is affacted by inflation due to two basic reasons : Firstly, due to speculative motive and secondly, due to the

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1/ A.S.Shaalan : 'The Impact of Inflation on the Composition of private Domestic Investment; I.M.F. Staff Papers : Vol.IX,No 2, July 1962, PP.243-261

precautionary motive. Inflation increases the value of effective liquidity, thereby raising the community's desire for it, but it makes the most generally accepted store of liquidity - money and financial assets denominated in money - unacceptable protection to provide against depreciation of value. This strengthening of the community's wish for liquidity and weakening of the traditional store of liquidity will exert the greatest influence on the types of investment undertaken during periods of inflation, but it will also work to reduce the total flow of resources available for investment.

In a stable economy, price movements are reasonably predictable and the variations in this rate are likely to become more pronounced as the average rate of inflation increases. This uncertainty regarding the future course of prices creates an incentive for liquidity. With this uncertainty about the future, the probability of unpredictable investment opportunities arise. Hence the desire to hold liquid assets for speculative and precautionary purposes is strengthened.

During an inflation money and financial assets denominated in money cannot be depended on as stores of liquidity, since they decline in real value as prices rise. Attempts are, therefore, made to acquire assets whose value is expected to rise in the interval before the investment opportunity or other occasion for disbursement arises. This flight into non-monetary assets is the source of many of the distortions which accompany an inflation, and this is a partial cause of the decrease in the flow of resources into investment channels.

Further, the process of development involves increasing requirements of credit to facilitate the expansion in economic activity. With the establishment of the new manufacturing activities and the extension of activity in agricultural and other fields there will inevitably be a rising demand for credit. The extension of credit

facilities to the rural areas has received particular emphasis in recent times. In India and Ceylon, during the last decade, a significant part of credit for agriculture was associated with an extension in lending to cooperative societies. In addition, it is desirable that resort to credit by rural producers from non-institutional sources at exorbitant costs be discouraged by the replacement of these sources by bank or cooperative credit.

In the context of inflationary pressures in the domestic economy there are two aspects of the rise in commercial bank credit that need constant attention. First, it is necessary to ensure that the increase in credit is primarily for productive rather than for consumption purposes and that financing for the speculative holding of stocks is minimised. Second, it is also important to ensure that the total of credit expansion is not excessive in the light of the overall monetary situation on the one hand, and the needs of productive activities on the other. It needs to be recognised that even credit for productive purposes could, if excessive, result in an intensification of inflationary pressures in the short-term.

The loss of past accumulations of external reserves implies that the countries concerned are no longer able to live beyond their means except to the extent that they have recourse to external borrowing. This implies in turn that these countries have to reduce the total use of resources each year, whether for consumption or investment, to what is available through production for internal uses and through such imports as could be obtained in exchange of their exports or from external borrowings. The inability to further draw down external reserves signifies that such an adjustment must take place whether or not

there is an excessive internal monetary expansion. The choice before these countries is whether to make these adjustments simply by means of import restrictions whilst monetary expansion continues unabated - in other words by an inflationary process of continuing price increases - or by a more regulated process by which the monetary expansion is itself restrained primarily by measures in the fiscal field, and the pressures on the price level are kept down to the minimum consistent with the requirements of a developing economy.

It needs to be recognised that an inflationary rise in prices is a means of distributing, over different sections of the community, the reduction in the use of real resources that has in any case to take place on account of the reduced volume of imports. As prices increase those whose money incomes are fixed or do not increase in proportion to the rise in prices are able to purchase smaller quantities than before and suffer a contration in real income and consumption.

On the other hand, those whose money incomes rise faster than the rise in prices enjoy an improvement in real income. In other words, in a process of inflation or rising prices there is a shift in the distribution of real income against the relatively fixed money income groups and in favour of those whose money incomes increase as a result of rising scarcity profits or other factors. Speculative activities, in particular, benefit from the process. It is essentially through such shifts in real incomes brought about in this way that a reduced quantity of real resources is distributed throughout the community in an inflationary process.

One of the chief drawbacks of an inflationary process, apart from the varying incidence of price increases on different sections of the community, is that it tends to gather momentum and becomes increasingly difficult to control. A rise in prices generated by such

a process is not likely to remain static at higher levels. As prices increase there are pressures for compensatory increases in money incomes. Wage and salary earners, for instance, are likely to exert pressures for higher money earnings. The increases, however, if conceded are likely to prove self-defeating. Although wage increases may confer temporary benefits they result in increases in costs which are in turn transmitted to consumers, including wage and salary earners, in the form of a further rise in prices and living costs. A cumulative spiral of rising prices, wages and costs could be set in motion over a period in this manner.

For a closed economy having relatively small transactions with the outside world, it may be argued that the effects of an inflationary process may be largely confined to continuing shifts in real income distribution, as described above, with relatively little effects on total production - even though productive activity can hardly remain wholly immune from the process. But in an open economy an inflationary rise in costs in the export sector cannot be passed on to consumers in the form of higher prices since the prices of export products are determined in markets abroad. A rise in production costs, with export prices remaining unchanged, can lead, in fact, to a contraction in export production as marginal producers lose their position of competitiveness. Such a result could only reinforce inflationary process by aggravating the balance of payments position and by creating a need for further curtailment of imports. Moreover, it would also impose additional pressures on the Government budget as revenues from export duties and income and profits taxes decline, and so enlarge the magnitude of the overall budget deficit.

There are also other ways by which a rise in prices tends to be continuous. The existence of shortages and scarcities and the expectation of further increases in prices encourages the speculative

hoarding of stocks of goods which itself aggravates the actual rise in prices. It is, in fact, the new pattern of expectations created by a price inflation that is a particularly insidious feature of the process and which, once under way, makes difficult a policy of restraint. Where further increases in prices are anticipated even increases in supplies find their way into speculative hoards.

It has to be recognised that there are several limitations in the way of successful price control and distribution policies in a general situation of excess demand. Price controls themselves tend to multiply and to make necessary an ever increasing network of controls over supplies and distribution. Price controls unaccompanied by effective rationing invariably result in either the circumvention of the controls or the disappearance of supplies from the market. Where available supplies fall short of demand at the controlled prices, scarcities cannot but occur. Yet a comprehensive system of rationing places great strains on the administration which a developing country can ill afford to bear. Moreover, the administrative costs of price controls and rationing are an additional component to the normal changes of distribution which needs to be borne by the budget.

This involves a reduction in the extent of the monetary expansion itself so that the volume of monetary demand in the economy is more in conformity with the availability of real resources. Such a reduction would result in a restraining of inflationary trends. An approach of this kind, however, must not be limited to the mere attainment of relative price stability. It must also be linked with the provision of a framework for accelerated economic growth. There will always be some scope in a developing economy for a certain degree of monetary expansion consistent, for instance, with the increases in production that takes place from year to year. It is possible that a

mild and gradual process of rising prices can act as a stimulant to investment and productive activity. But the choice under discussion is not one between static as against gently rising prices. It is rather a choice between an inflationary process that might prove increasingly difficult to control and a framework of relative though not absolute, price stability.

The control of inflation is only one of the problems facing a government wishing to encourage rapid economic development. The fight against illiteracy, the reform of bureaucratic practices, the building of basic sanitory facilities for the eradication of endemic diseases, the substitution of competitive for monopolistic trade practices, the encouragement of a widespread spirit of entrepreneurship, and the creation of an adequate amount of social capital, may be important pre-requisites for rapid economic growth. However, attacks on these problems are likely to be more feasible in an atmosphere of financial stability and rapid inflation will make the failure of such attacks much more likely.

Inflation creates distortion and, therefore, inflation-ridden economy needs complete reorientation of the economic system. Drastic changes should be made in the community's expectations. These changes are not likely to occur if the community believes that the government may be lukewarm in its attack on inflation. If individuals see little change in the economic climate they will be under very few effective pressures to change their views. The fundamental changes which are required will not take place.

The persistence of expectations as to the movements of prices is a particular problem to be faced in introducing a stabilization programme. In the early stages of an inflation, individuals may continue to believe that prices will soon stop increasing. But once inflation is

established, they will expect prices to go on rising; and even if they believe that the inflation has been halted, and that prices will be stabilised they will not expect stabilization to take place immediately. Moreover, they will always be conscious of the possibility that the programme may fail. Even, therefore, when money and financial assets begin once more to appear attractive, the acquisition of such assets may be deterred by a lingering fear that they may again decline in real value. By contrast, the continued holding of inventories offers protection, even if the programme succeeds, against any loss except that of the potential income from financial investments, and the holder of foreign financial assets risks the loss only of the possibly excessive returns on domestic financial assets over the return on foreign ones. If the programme fails, such holders stand to gain much more. Thus to enable a stabilization programme to succeed, it is above all necessary for the Government to convince the community that the value of money will henceforth be maintained.

An attempt to slow down an inflation will take a long time to be effective and its financial result will be uncertain. The restrictions on credit necessary to bring some stabilization will deter borrowers from investing, but the inflation - induced distortions of the economy are likely to persist. The continued rise in prices will deter the accumulation of financial assets and continue to act as a brake on the flow of resources to investment, and unless the authorities are firm in their attack, the atmosphere of financial stability necessary to induce a revival of output to levels higher than those which would have prevailed under inflation will not emerge.

Hence the control of inflation should be one of the major objects of economic policy in a developing economy. It is true that, <u>per se</u>, rapid economic development is likely to provoke inflationary pressures. Therefore, one of the problems calling for high priority on

the part of the authorities in a rapidly developing economy is the restraint of inflation.

Inflation diminishes the volume of resources available for domestic investment. Community saving is reduced, and a considerable part of this saving is channelled to foreign rather than domestic investment, while the flow of capital from abroad is discouraged. A substantial part of the reduced flow of resources for domestic investment is diverted to uses which are not of the highest social priority. The accumulation of the large inventories is encouraged. The diversion of savings from the capital markets, where investment dicisions are more subject to longer-term economic criteria, is exemplified by the diversion of investment from productive uses for the entire community to the building of owner-occupied housing for the relatively wealthy few. The apparent profitability of certain short-lived investments leads to distortions in the productive structure which makes the economy less adaptable. Balance of payments difficulties are symptons of the underlying stresses. To reduce the foreign deficits, the authorities are almost forced to resort to controls, which in most cases protect uneconomic production.

However, if the economic system has been allowed to get out of hand, the authorities must decide to stabilize, or not to stabilize. There is no doubt that the provess of stabilization is difficult, but difficult or not, it is a pre-requisite to rapid economic growth.

The overriding need in the context of underdeveloped countries is to step up the rate of economic growth so as to outstrip the growth of population and to provide employment opportunities for an increasing labour force. This objective calls for a significant rise in the rate of investment in the economy and the mobilisation of financial resources towards this end. Given the limits of external financing, this calls in turn for a fuller mobilization of domestic financial resources for

purposes of investment. Ceylon has had a greater degree of success than many developing countries in channelling substantial financial resources to Government revenue. Government revenues represent a higher proportion of national income in Ceylon-nearly 26 per cent - than in most of these countries. In India also Government revenues come to about 26 per cent of national income. Nevertheless, the heavy claims made by current expenditures on the financial resources of Government set limits to the magnitude of resources that could be devoted to investment. At the same time, there are limits to the amount of financial resources for accelerated investment that could be prudently provided by expansionary financing.[2/]

The policy requirements for the mobilization of domestic financial resources would be readily apparent in the perspective of a development plan which sets out the investment requirements for an accelerated rate of economic growth. Given the magnitudes for external financing and permissible monetary expansion, the objectives in respect of Government revenues and current expenditures would be nore easily determined. The question of an appropriate scale of subsidy outlays, for instance, could be approached in terms of such a framework. It needs to be recognised in this connection that in the more recent period the relationship between subsidies, budget deficits and the price level has changed significantly. As long as external reserves were plentiful and imports flowed in freely, expansionist financing of Government budgets, whether for the maintenance of subsidies or otherwise, had no impact on consumer prices or on living costs. The cost of subsidies, in other words, was not borne by consumers through increases in other prices but by the decline in external reserves. In the present situation, on the other hand, although the prices of the subsidised items remain low, excessive expansionary financing results in a sustained **increase** in

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2/ Central Bank of Ceylon Annual Report for 1963, PP.18,19

other consumer prices as well as in shortages of several categories of goods. A development plan will not only indicate in specific terms the appropriate allocation of resources between consumption and investment, it will also depict the scope for further augmenting revenue. Instruments of taxation in a developing economy need to be progressively adapted towards channelling to revenue a part of the increment to incomes that accrue in the course of development and particularly a part of what would otherwise be diverted to consumption. Further, in conditions of relative scarcities high import duties, sales or turnover taxes, and excise duties are effective instruments for augmenting revenues and reducing scarcity profits.

A tax system based on direct taxes which are graduated in a progressive manner is important both for financing economic development and for controlling inflation. Economic development raises per capita income and money income and the whole population moves up in the income scale. Those who were paying taxes earlier will pay larger taxes, and some of those who were below the exemption limit will start to pay taxes. The direct tax system thus has a built-in structure for giving governments larger revenues from growth without changing the level of taxation.

The progressive direct tax system also provides governments with built-in protection against inflation. When prices rise, money incomes increase, and the tax system causes government revenues to increase at least pari passu with national income and very rapidly if the system is sufficiently progressive. On the other hand, if indirect taxes are a larger component of revenue, government revenues will lag behind the increases in money income and prices. And if, as in most underdeveloped countries, expenditures increase with rising prices, the

budget deficit grows rapidly, adding to the total excess demand and inflationary pressures. In India, indirect taxation accounts for about 60 per cent of the revenues of the Central Government and the masses have to contribute substantially to the funds required for planned growth.

In order to promote investment and to create capital markets, it is desirable that preference be given to the corporate form of enterprise. One of the difficulties in raising the level of private investment in underdeveloped countries is that even the rich do not have sufficient funds to establish industries using modern methods of production. This difficulty can be overcome only by encouraging large numbers of investors to pool their financial resources.

That government revenues in underdeveloped countries are woefully inadequate is clear, but the method by which they can be increased rapidly is not so obvious. Particular tax devices, which work successfully in one country may not be appropriate in another. However, there are three fronts along which governments could advance, namely tax principles, tax administration, and social and political will to succeed. It is true that refined knowledge is often lacking about the kinds of taxes which will yield the highest revenues with the least amount of economic, and perhaps political disturbance.

Better tax administration and improved collection methods within the existing structure will produce results, and they are certainly important as a means of increasing government revenues. In most countries, the staff of the tax collecting departments is inadequate.3/ This requires better training in accounting and in methods of making assessments.

Tax reforms, as mentioned above, can be made only slowly. They depend not only on good laws, but also on how the laws are implemented.

3/ I.M.F.Staff Papers : Vol. IX, No.3, November 1963; PP.444-445.

If tax systems are judged by the amount of revenue collected in relation to the gross national product, some improvement has occurred in post-war years in a number of countries like Burma, India and Philippines, but in the majority of the cases there has been very little or no change in the ratio. When tax systems are judged by the proportion of direct taxes to total tax revenue, improvement since the war is indicated for only a few countries : Burma, Ceylon and India.

In the post-war period, the decisive efforts of these countries to achieve planned economic development have added new dimension to their external trade problems. Their determined and intensified drive towards betterment is clearly reflected in the import needs of the national development plans. Generally, however, imports are scheduled to rise at a much slower rate than in the past and the composition of the planned imports continues to reflect on increasing emphasis on developmental goods. To a much more significant and crucial extent, in making plans for imports, countries have had to take cognizance of the availability of foreign exchange resources.

Development activity within the region has not been well planned in respect of trade. It has led to duplication of efforts and to difficulties in expanding markets beyond national boundaries, resulting in inefficient production and waste of resources. Positive action on the economic front by countries of the region is long overdue. While a broad-based scheme of regional autarky may not be immediately feasible, the scope for coordinated action in specific fields is not only feasible but essential. An import substitution programme on a regional scale would be more ~~xx~~ sensible and mutually beneficial than mere import substitution exports within individual national boundaries.

A well thought out attempt to achieve greater coordination of the developmental efforts within the countries of south-east Asia is urgently called for. This is particularly so in those fields of

activity which will have repercussions on intra-regional trade. In the context of the growing difficulties attendant on development, the time certainly is ripe for the countries of the region to take important steps which will benefit the individual countries by creating common benefits to the region as a whole. Only through such coordinated efforts will the countries of the region be able to take full advantage of the opportunities open to them in the future.

Of course with successful regional trade cooperation, the bulk of the capital goods needed by the developing Asian countries will have to be imported from the more advanced nations. Since it is on capital goods imports that countries of the region apply minimal restrictions and since the levels of imports of these countries are governed by the availability of foreign exchange, it would be to the interests of the developed countries too if they liberalize their imports from the developing countries. This is of even more basic importance to the economic development of these countries than the grant of aid.

Foreign capital is essential for financing import requirements. In view of the region's prospective foreign exchange difficulties and its mounting debt burden it is essential that aid should be made available to these countries on liberal financial terms. The terms on which aid is offered are generally governed by the purpose which ranges from budgetary support through social and economic infra-structure investment to profit-making projects in manufacturing industry. Political and military considerations also have an important effect on the availability and financial conditions of aid.

The developing countries in the region will continue to rely heavily on developed countries for long-term capital to finance import requirements. A powerful case exists for aid in the form of grants, particularly for social and economic infra-structure projects and for countries in foreign exchange difficulties, even if the projects most

needing finance are profit-making industries. To the extent that loans have to be made, their terms and conditions should be increasingly geared to the requirements of borrowing countries without jeopardising the financial soundness of the aid-giving country's aid programme. Loans carrying low interest rates and longer grace and maturity periods need not be burdensome to countries giving aid, nor need they impair the role of domestic capital in developed countries, provided suitable discriminatory measures are desired to favour foreign borrowers.

The long-term solution, however, for their foreign exchange problem is increased exports and substitution of local outputs for imports. But both of these developments depend largely on capital formation and economic growth, so that foreign capital is still crucial for the economic programmes of many underdeveloped nations.

These countries must look to exports for much the greater part of the foreign exchange needed to finance imports that assist improvement of agriculture, industry and transport. Although foreign aid has become important, and should become more important in the development decade, exports provide these countries with about 87 per cent of their foreign exchange receipts. The target of a 5 per cent rate of increase in national incomes of developing countries will, therefore, require much the same rate of increase in their exports.

World trade has been increasing at more than this rate, for between 1953 and 1960, the value of world exports rose by 6.? per cent a year. Export receipts of the Asian countries, excluding Japan whose receipts trebled, increased at a considerably slower rate of 4.6 per cent a year.

It is obviously urgent that the countries of Asia should have wider opportunities for exporting to developed countries, and

foreign aid, however generous, is not an adequate substitute. But such opportunities cannot be taken for granted and the slowest rates of growth, both in value and quantity of exports, have occurred for trade between developing countries themselves. It is here that they might do more to help one another reach the target of the development decade. Measures to increase trade between them could help conserve their aggregate resources of foreign exchange for imports from developed countries and notwithstanding substantial increases of foreign aid, such conservation will become increasingly necessary as development programmes are strengthened.

Development would not, of course, be helped by ill-considered measures of trade diversion that make imports scarcer, and so reduce their volume or quantity. But, as development proceeds, it should open wider possibilities for competitive ~~xx~~ exports from some developing countries to others, and if these possibilities are promptly realized, further development will be assisted thereby. It would be assisted in a two - fold way. The countries whose competitive exports gained would have bigger markets for achieving economies of scale and greater receipts with which to obtain their own import requirements. They could, in turn, help the purchasing countries by issuing some of their extra receipts to buy foodstuffs, minerals, other raw materials and perhaps some light industrial goods.

In the final analysis it is only an acceleration in the pace of economic growth that can provide a solution to the

basic problems of underdeveloped countries. It is because such an acceleration will prove difficult in a context where the monetary expansion is excessive and inflationary pressures too severe that there is need for a reduction in the fiscal and monetary imbalance in the economy. In this respect, the key position and the immense responsibility of the central bank in securing monetary and general economic equilibrium must not, however, be challenged. If the threat of excessive demand prevails, no other institution can operate as promptly and or as effectively. Under these conditions the central bank will have to devote its efforts to reaching a satisfactory compromise between domestic and foreign requirements. At the same time, it is necessary to keep under control the purely administrative expenditure of the Government so that funds for productive investment may continue to grow. The benefit of economic growth must pass on to the masses. Only then is balanced economic growth feasible.

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TABLE NO. I

Origin of National Income *

(Percentage of the total National Income)

Source of origin	Year	Burma	Cambodia	China (main land)	China Taiwan	~~China~~ Malaya & Singapore	Hong-Kong	India	Indonesia	Pakistan	Philippines	Thailand	(b) North Viet-Nam	South Viet-Nam	Ceylon
Agriculture Forestry and Fishing	1952	- -	-	-	-	-	-	-	(a) 53.1	-	-	-	-	-	-
	1953	42.3	52.1	-	39.3	39.8	-	50.8	-	59.2	42.9	46.5	-	-	53.7
	1954	-	46.6	-	35.4	-	3.0	45.3	-	58.8	43.6	43.0	-	-	54.6
	1955	42.0	41.3	-	33.9	-	-	45.3	-	58.5	41.5	43.1	-	28 .2	52.3
	1956	40.5	44.1	48.2	32.9	-	-	49.9	-	57.7	39.7	40.3	-(b)	30 .2	50.0
	1957	42.0	43.7	-	32.3	-	-	-	-	-	37.7	-	71.0	-	-
Manufacturing	1952	-	-	-	-	-	-	-	-	-	-	11.6	-	-	-
	1953	11.2	6.8	-	14.6	-	-	15.9	-	9.0	11.9	12.3	-	-	5.8
	1954	-	5.8	-	16.3	-	33.0	17.7	-	9.9	11.9	12.7	-	-	4.7
	1955	10.8	7.8	-(c)	16.7	-	-	17.6	-	9.9	13.2	12.4	-	9.5	5.9
	1956	10.5	8.7	26.4	17.1	-	-	16.3	-	11.0	13.0	12.8	-	9.6	4.7
	1957	10.4	8.4	-	18.1	-	-	-	-	-	14.0	-	29.0	-	-
Wholesale or retail sale	1953	28.8	17.5	-	12.9	54.2	-	16.4	-	9.3	11.1	15.4	-	-	7.3
	1954	-	22.3	-	17.3	-	17.6	18.0	-	9.4	10.9	17.5	-	-	6.0
	1955	24.3	21.2	-	15.7	-	-	17.9	-	9.5	11.3	19.4	-	25.8	5.9
	1956	26.6	19.9	15.5	16.4	-	-	16.0	-	9.4	11.4	19.6	-	26.4	6.5
	1957	25.8	21.8	-	16.5	-	-	-	-	-	11.8	-	-	-	-
Mining	1953	2.3	0.7	-	1.5	6.0	-	0.9	-	0.1	1.6	1.6	-	-	0.1
	1954	-	0.9	-	1.3	-	0.3	0.9	-	0.1	1.4	1.6	-	-	0.1
	1955	1.5	2.1	-	1.5	-	-	1.0	-	0.1	1.6	1.5	-	0.1	0.1
	1956	1.5	0.5	-	2.2	-	-	0.9	-	0.1	1.6	1.7	-	0.2	-
	1957	1.5	0.6	-	2.3	-	-	-	-	-	1.8	-	-	-	-

Percentages have been calculated from U.N.Economic Survey for Asia and Far East, Annual Report, 1958

(a) Source : Indonesia's Economic Stablisation and Development; B.Higgins ; P.177; 1957
(b) Economic Development in North Viet-Nam; Theedore Shabad, Journal of Pacific Affairs; Vol.XXXI,No.1,March 1958
(c) Mining and Manufacturing both

TABLE No.2 APPENDIX 'A'

TREND OF THE PERCENTAGE OF DIRECT AND INDIRECT TAX REVENUE TO THE TOTAL TAX REVENUE IN SELECTED COUNTRIES

Country / Year	INDIA (a) Direct: Tax Revenue	INDIA (a) Indirect: Total indirect tax revenue	INDIA (a) Indirect: Customs as percentage of total tax revenue	CEYLON (b) Direct: Tax revenue	CEYLON (b) Indirect: Total indirect tax revenue	CEYLON (b) Indirect: Customs as percentage of T.T.R.	INDONESIA (c) Direct: Tax Revenue	INDONESIA (c) Indirect: Total indirect tax revenue	INDONESIA (c) Indirect: Customs as percentage of total Tax revenue	PHILIPPINES (c) Direct: Tax revenue	PHILIPPINES (c) Indirect: Total indirect tax revenue	PHILIPPINES (c) Indirect: Customs as percentage of total tax revenue	THAILAND (c) Direct: Tax revenue as percentage	THAILAND (c) Indirect: Total indirect tax revenue	THAILAND (c) Indirect: Customs
1947-48	-	-	-	20.3	79.7	66.2	-	-	-	-	-	-	-	-	-
1948-49	-	-	-	22.3	77.7	65.1	-	-	-	-	-	-	-	-	-
1949-50	-	-	-	22.6	77.4	65.4	-	-	-	-	-	-	-	-	-
1950-51	-	-	-	18.5	81.5	70.2	-	-	-	-	-	-	-	-	-
1951-52	47.1	52.9	-	27.1	72.9	62.7	-	-	-	-	-	-	-	-	-
1952-53	-	-	-	30.6	69.4	57.3	-	-	-	-	-	-	-	-	-
1953-54	-	-	-	27.1	72.9	60.7	23.8	76.2	27.8	18.7	81.3	5.4	7.3	92.7	34.9
1954-55	-	-	-	22.7	72.3	67.1	30.7	69.3	19.6	18.9	81.3	44.5	7.0	93.0	34.9
1955-56	49.6	50.4	-	29.8	70.2	58.2	31.3	68.7	18.8	19.2	80.8	33.4	7.8	92.2	41.3
1956-57	50.7	49.3	-	26.5	73.5	60.7	22.8	77.2	16.7	18.7	81.3	33.3	7.6	92.4	39.0
1957-58	43.8	59.7	-	26.1	73.9	59.2	24.1	75.9	14.6	17.9	82.1	32.4	8.1	91.9	40.6
1958-59	40.3	59.7	-	19.5	80.5	65.0	22.1	77.9	15.4	15.5	84.5	31.2	8.3	91.7	37.1
1959-60	42.3	57.7	-	18.0	82.0	65.2	-	-	-	-	-	-	-	-	-
1960-61	38.3	61.7	-	26.6	73.4	57.5	-	-	-	-	-	-	-	-	-

Percentages have been calculated from

(a) Report on Currency and Finance for the year 1959-60; Statement 56, Reserve Bank of India, 1960
(b) Central Bank of Ceylon Annual Report for the year 1960; Table No.20
(c) U.N. ECAFE : Annual Report 1958, P.171

End of period Year	Total Deposits	Demand Deposits			Savings Deposits			Time Deposits		
		Total	Government	Private Business	Total	Government	Private business	Total	Government	Private business
1948	865.2	585.0	302.7	282.3	258.2	-	258.2	22.0	-	22.0
1949	739.4	455.4	164.4	291.0	255.0	1.0	254.0	29.0	2.0	27.0
1950	862.5	567.6	177.3	389.7	255.4	-	255.4	40.0	0.3	39.8
1951	748.9	457.8	164.2	293.6	249.3	-	249.3	41.8	1.8	40.0
1952	832.6	520.4	215.7	304.8	269.3	0.4	268.9	42.8	0.8	42.0
1953	908.3	520.3	241.9	278.4	316.2	0.1	316.1	71.8	11.8	60.0
1954	961.6	534.1	239.4	239.7	354.8	0.5	354.3	72.7	6.9	65.8
1955	1,121.7	641.5	294.7	346.8	383.6	1.6	382.0	96.6	10.3	86.3
1956	1,303.6	739.4	337.2	402.2	462.1	10.3	451.8	102.1	16.4	85.7
1957	1,373.3	709.7	277.1	432.6	542.8	24.6	518.2	102.1	20.0	100.8
1958	1,506.7	741.0	235.2	505.8	619.8	37.0	582.8	145.9	23.3	122.6
1959	1,661.6	776.2	229.9	546.3	700.2	65.6	634.6	185.2	49.5	135.7

TABLE No.4

Statement of the Savings Deposits of the Postal Savings Bank in Philippines (1949-59)@

(Million Pesos)

Year	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
Savings Deposits	31.6	22.8	29.8	30.5	33.1	33.9	35.4	38.5	41.6	42.0	44.5

* Central Bank of Philippines, Statistical Bulletin, P.71, Vol.XI,No.4,December 1959.

@ Ibid : P.93, Table No.47

Table No.5

Savings and Gross Domestic Capital Formation in China-Taiwan *
(1951-1957)

	1951	1952	1953	1954	1955	1956	1957
Gross Domestic Capital Formation	2,397	3,464	3,832	4,136	4,064	4,731	5,947
Savings	1,121	1,899	2,094	1,761	2,007	1,166	1,498
a) General Government	7	266	235	211	307	177	490
(b) Public Corporation							
(c) Private Corporations							
d) House Holds and Private non-profit institutions	1,114	1,633	1,859	1,550	1,700	289	1,008
Savings as percentage of gross capital formation	46.4	47.1	48.5	37.4	41.8	20.9	16.9

* Year Book of National Accounts Statistics : U.N., 1958, P.49

APPENDIX 'A'

TABLE NO.6

Loans Granted and outstanding of Insurance Companies in Philippines classified by purpose (1956-1959) *

	No. of operating companies	Total Loans Amount	Total Loans Percentage	Agriculture Amount	Agriculture Percentage	Industrial Amount	Industrial Percentage	Commercial Amount	Commercial Percentage	Real Estate Amount	Real Estate Percentage	Consumption Amount	Consumption Percentage	Others Amount	Others Percentage
January 1956															
1. Loans granted	103	4328	-	12	0.27	29	0.67	486	11.2	468	10.8	3099	71.6	234	5.4
2. Loans outstanding		71316	-	897	1.02	373	0.52	1781	2.5	22194	31.2	45270	63.3	801	11.3
January 1957															
1. Loans granted	102	4786	-	-	-	-	-	657	13.9	725	15.1	3074	64.2	330	6.9
2. Loans outstanding		75998	-	647	0.85	643	0.84	1523	20.0	20987	27.6	50905	67.0	1297	17.0
January 1958															
1. Loans granted	108	5680	-	16	0.28	35	0.61	493	8.6	815	12.5	4159	73.2	162	28.5
2. Loans outstanding		86288	-	521	0.67	545	0.64	2095	2.4	24674	28.6	50098	58.0	8295	9.6
January 1959															
1. Loans granted	108	7553	-	15	0.19	23	0.2	597	7.9	1924	25.6	4888	64.7	106	1.4
2. Loans outstanding		98842	-	506	0.51	686	0.69	3092	31.3	27958	28.2	65972	66.7	628	0.6

* Prepared from Statistical Bulletin, Central Bank of Philippines, Vol. IX, No. 4, December 1957, Table No. 36 and 37, Vol. X, No. 4, December 1958, Table No. 33 and 34, Vol. XI, No. 4, December 1959, Table No. 48 and 49.

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